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# Russia's Social Protection Malaise: Key Reform Priorities as a Response to the Present Crisis

Edited by Michal Rutkowski

April 1999



# **RUSSIA'S SOCIAL PROTECTION MALAISE**

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## PREFACE

The study is a reaction to the August 1998 financial crisis. The study has been prepared by a team led by Michal Rutkowski and comprising Jeanine Braithwaite, Alexandre Marc, Mansoor Rashid, Hjalte Sederlof, and Milan Vodopivec. Anastassia Alexandrova, Andrei Markov and Elena Zotova from the Moscow Resident Mission, and Karen McConnell Brooks and Teresa Ho contributed to parts of the report and offered invaluable insights and advice. The study benefited from the August social crisis note written by a team led by Maureen Lewis.

The team visited Russia from November 11-20, and worked closely with Russian counterparts in Moscow and in the raion of Ruza (Moscow oblast). The team is grateful to the government, both at the federal and oblast level, as well as to the Ruza officials, for their assistance, hospitality and guidance. The team visited Russia again from December 8-12, 1998 for review of the first draft with government officials and other stakeholders. The intra-Bank review of the first draft of this study was held on December 10, 1998. Subsequently, a senior policy seminar for the Russian government was held in Bor (Moscow oblast) on January 16-17, 1999, with the participation of Deputy Prime Minister Ms. Valentina Matvenko and the Minister of Labor and Social Policy, Mr. Sergei Kalashnikov. The revised study was presented to the Executive Board of the World Bank on March 24, 1999.

The study benefited very much from comments of the participants of the seminar, both those from the government as well as those who came from various regions of Russia, including regional and local governments and NGOs. Inside the Bank, the report was helped by suggestions of Marcelo Selowsky and by comments provided by Robert J. Anderson, Anush Bezhanyan, Mary Canning, Michael Carter, David Craig, Katy Dahlmaier, Michael Fuchs, Robert Holzmann, Jeni Klugman, Arvo Kuddo, Chris Lovelace, Maureen Lewis, Ricardo Martin, Pradeep Mitra, Gillian Perkins, Aleksandra Posarac, Jeff Procak, Brian Pinto, Mark Sundberg and Michael Walton. Gillian Perkins helped with editing and Annie Milanzi, Nicole La Borde and Sidonie Jocktane put in shape the text and the tables.



## EXECUTIVE SUMMARY

1. This report focuses on changes in the social protection system to lessen the social impact of the economic crisis that confronts the Russian Federation today. The report is not comprehensive and covers exclusively the crisis-related issues. It addresses the key challenges of (i) coping with income decline and increasing poverty, (ii) offsetting the consequences of reduced public expenditure in the social sectors, (iii) targeting and delivering social assistance and benefits, and (iv) improving the functioning of labor markets. It also deals with selected aspects of emergency assistance. Finally, it identifies possible areas for Bank support.
2. The report identifies the major pre-crisis vulnerabilities in the labor and social protection area: the malfunctioning labor market resulting from the lack of enterprise restructuring; increasing poverty and inequality; and the failure of the state social protection system to deliver targeted benefits in an efficient way. These pre-existing vulnerabilities were aggravated by the shock that began as a financial crisis, but that is now evolving into a significant decline in real wages, incomes and standards of living. The report finds that the August 1998 shock did not create any new or unprecedented problems for Russia's social protection system. All of the problems existed in Russia before the crisis in the form of a persistent malaise. The crisis deepened the problems and made it clearer than ever that Russia just cannot afford any longer to postpone dealing with them. Therefore, even though it is essential to confront the immediate social fallout of the crisis, it is also of crucial importance to shape responses in the context of medium-term changes and development challenges.
4. The decline in real incomes is expected to lead to (i) a cumulative drop in average income in the period 1998-99 of about 13%, and (ii) an even more serious decline in social expenditures related both to the GDP per capita drop and to the expected further decline in tax and social security revenue collection. The extreme poverty rate is expected to increase from 15% to 18.3% of the population, while social expenditures financed by regional governments (general education, public health, social assistance) are predicted to decrease by about 15%.
5. The peak of the crisis is expected to come next year. In the short term, supplies of food and pharmaceuticals are expected to experience problems, but these problems can be solved without any major new Western assistance beyond deliveries already promised. As opposed to this, the medium-term consequences of the shock will require additional actions.
6. First, expenditures with high externalities on social assistance, primary schools, and health activities (such as immunization and protecting children from an irreversible adverse impact of the crisis) should have a priority. Second, the social protection system needs to be restructured with three objectives in mind: (i) radical improvement in targeting of government provided social assistance; (ii) strengthening the delivery of social assistance and social services by building a supplementary delivery mechanism of a social fund-type to deal with issues ranging from extreme cases of social destitution, to other assistance measures that meet the needs of beneficiaries; and (iii) setting up or strengthening programs that can facilitate enterprise restructuring and downsizing, if needed, by providing an adequate social safety net for displaced workers.

7. Financing of expenditures which are absolutely necessary could come from within the social protection system, primarily from turning the untargeted part of subsidies for housing and related utility services into a targeted benefit focused on the poorest. Those subsidies account for more than 3% of GDP. The federal government should use its fiscal leverage to impose conditions on federal transfers, and take the leadership in promoting the reform agenda.

8. The targeting system requires a fundamental overhaul. In Russia, because of the enormous difference between reported income and consumption (attributable to the unofficial market), traditional means-testing methodologies do not work. This is why the government has wisely supported developments of a new approach on an experimental basis. The difference between what households actually consume and the official income they report (either to a survey interviewer or a social worker), is central to the three pilot methodologies that have been introduced experimentally in the Komi Republic, and in Volgograd and Voronezh oblasts. Each of these methodologies aims to estimate the potential household consumption based on measurable indicators, and to use this consumption to determine eligibility for social assistance. The successful implementation of the three different targeting systems in three very different oblasts of Russia demonstrates that significant progress can be made. It is imperative to extend the experience of the pilots to those regions which could benefit quickly from improved targeting methods and ultimately to implement the new approach nationwide.

8. Strengthening the delivery of social assistance and social services is difficult to impossible without an environment which (i) favors a clear sharing of responsibility between the federation, the regions and the local level structures (raion, municipalities, NGOs); (ii) encourages the participation of the population and local level institutions in the delivery of services; and (iii) ensures adequate control and accountability in the use of funds, while channeling those funds rapidly to finance visible activities that help the poor and vulnerable groups. To foster such an environment, it is advised to complement the existing delivery system with a social fund-type mechanism. This has been implemented successfully in some former Central and Eastern European countries and CIS republics. Such a mechanism is particularly suitable for financing priorities that are identified by municipalities, local associations, NGOs or local administrations, including high priority rehabilitation of local infrastructure such as sanitation systems, schools, and roads or other types of public works. The social-fund mechanism could also be a helpful tool to address the problem of institutionalized children, and to complement existing state outreach programs for pensioners living alone and for the handicapped outside institutions.

9. The adjustment of employment to output has been much smaller in Russia than in Central and Eastern Europe. There are several reasons for that: (i) insider privatization which makes managers unwilling to engage in firing old workers and hiring new ones (ii) the lack of an adequate social safety net for displaced workers in Russia, and, as a result, (iii) unwillingness of creditor firms, utility companies and the federal government to insist on payments of tax and credit arrears, for the fear of the consequences of bankruptcy. Losing a job means not only receiving a low unemployment benefit, but often also losing many benefits which have traditionally been supplied by the firm. Moreover, the current decentralized system of unemployment benefits provision (which prevents surplus funds in some regions to be used in deficit regions) strengthens regional disparities in the level of unemployment assistance and does not facilitate job search. The government should aim at centralizing provision of unemployment benefits and increasing their level; as well as setting up special severance pay schemes whereby workers would be eligible for one-off payments conditional upon enterprise restructuring or closure.



10. As the peak of the crisis is expected to come in about 12 months, rather than now, additional financing of social needs from the Bank could be provided in the time frame that fits the envisaged scenario. The additional Bank resources should focus on those areas and locations where the Bank can (i) at least moderately influence resource allocations to social protection and social investment needs; (ii) foster experiments in new designs of social assistance targeting, that stand a chance of providing increased protection and can provide a sounder basis for long-term reform. These are relatively modest objectives, but still with significant risk of failure in view of serious economy-wide problems and uncertainties in Russia.

11. The Bank's contribution, therefore, to additional government actions should take four forms: (i) the Social Protection Adjustment Loan third tranche has been restructured to incorporate important conditionalities related to minimum benefits and crisis alleviation; (ii) implementation assistance to the ongoing reforms should be continued, and (iii) a new Local Social Protection Delivery Project, focused on the new and tested targeting mechanism, and on building an effective and efficient social assistance and social services delivery mechanism, should be developed as quickly as possible. These actions are critical to protect the poor as the crisis has left Russia with extremely limited resources to deal with poverty and social exclusion. For the more distant future, when adjustment lending to Russia is fully restored and the reform program accelerates, the Bank could consider a fourth action, in the form of direct assistance in financing severance pay to strengthen the social safety net for workers laid off during major enterprise restructuring. Such assistance could start with some local governments, focusing on regions willing to accelerate privatization and enterprise restructuring as part of an enhanced environment for private sector investment.

12. The social impact of the crisis is going to be different for different people living in various places. It will particularly affect those in small towns and rural areas and in families with many children. The disaggregation of social impacts region by region is vital for determining what types of responses should be designed and funded, and how programs should adapt if local conditions change. Also, as highlighted in the analysis of crises elsewhere, including East Asia, more effort should be invested in understanding the relationships between political structures—at central, regional and local levels—and effective reforms. This requires that international and donor organizations take more steps towards expanding their relationship with the regional and local governments and with civil society organizations, both for policy dialogue and for research on social impacts. It also requires that stakeholders at the local level, the ultimate beneficiaries, are brought on board more than ever in shaping responses to the problems emerging for them.



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## **CHAPTER 1: PRE-CRISIS VULNERABILITIES, POVERTY AND INEQUALITY**

1.1 The August 17, 1998 crisis stopped the period of recovery of the Russian economy that started in 1997. The crisis was related to pre-existing vulnerabilities. In the labor and social protection area there were three crucial handicaps: (i) the lack of enterprise restructuring and continued support of unviable enterprises, with wage and transfers arrears becoming a modern counterpart of shortages under communism; (ii) high and increasing poverty and rising inequality, and (iii) inefficiency of the social protection system and the shortcomings of the state benefits delivery system resulting in huge arrears and growing number of barter transactions.

### **LABOR MARKET PECULIARITIES**

1.2 Important impediments to the social protection system reform are related to the peculiarities of the Russian labor market. In Russia, in contrast to many Central and Eastern European countries, employment reduction has lagged far behind declines in output and labor hoarding has increased. Growing wage arrears (see Annex Table 2), wage payments in kind, and a real decline in wages (currently 50% of 1991 levels) have been the main modes of labor market adjustment to declines in real output, as opposed to quantity adjustment in the number employed. Employment has decreased from 75 million in 1990 to 64 million in September 1998 (by 14%), while GDP fell simultaneously by more than 40%. Many workers have been forced to take administrative leaves (16% in 1996). Although open unemployment measured by surveys reached over 9% in 1997 (Annex Table 1), registered unemployment was only 3.2%, reflecting low levels of benefit (in the second quarter of 1998, the ratio of average benefit to average wage was 30%), and growing arrears in benefit payments.

1.3 Those trends, indicating limited enterprise restructuring and insufficient labor shedding, are related to the dominance of insiders among shareholders of Russian enterprises—a result of the voucher privatization of the early 1990s. Goldberg and Desai (1998) report that 50-60% of the shares of enterprises are in the hands of insiders, employees and managers. Under these circumstances, managers have much less leeway to adjust the workforce because their decisions are liable to be blocked by company boards. Several other factors contribute to the reluctance of managers to lay off workers: the manager's own position may be jeopardized; managers feel a sense of paternalism and social responsibility towards their workers; they often hope for an increase in demand for their products; and they want to avoid high separation costs. There is some evidence that managers are avoiding separation costs by making selective use of wage arrears to force surplus workers to leave "voluntarily."

1.4 Employees themselves are reluctant to leave formal enterprise rolls, even when they are involved in the informal economy, when they have been forcibly placed on administrative leave, and when they have no recourse to obtain payment of accumulating wage arrears. This is not surprising, given the low levels of unemployment benefits and severance pay, and the arrears in benefit payment, which mean that workers who would leave, or who would be laid off, have no effective protection. At the same time, they are able to use their insider power to stay on the rolls. As a result, Russian enterprises settle for formal employment levels far above the efficient level. The fact that the labor code has not been reformed since the transition started, and contains several unrealistic protective measures, does not encourage compliance even with those articles which should be complied with under any circumstances (see Box 1

on legal provisions and reality in Russian enterprises). At the same time federal and regional governments are not interested in enforcing timely payments of taxes and other financial obligations by enterprises, since this would lead to layoffs which would shift the burden of social protection to the government. As a result, so called *soft-budget constraint* persists (Buckberg and Pinto, 1998)

1.5 An additional peculiarity of the labor market in Russia is the legacy of Soviet policy to promote labor migration to the North by creating permanent populations resident in large urban settlements rather than relying on smaller, more temporary populations (as in other countries). This practice has led to many more people residing in the Russian North than in comparable Northern countries elsewhere. The current large population is in increasing need of assistance for outmigration.

#### **Box 1: Legal Provisions And Reality In The Russian Labor Market**

In the Russian transition to market, workers pay a heavy toll. Beside suffering substantial hardship imposed by the fall in earnings, their workplace rights are often violated. But they have little recourse to legal actions. Pervasive wage arrears are but one blatant example of violations of the labor code. Indeed, most of the 1.2 million cases of violation of working rights brought to Russian courts in 1997 were wage-related. The fact that the majority of these cases were solved in favor of the workers was of little avail, because there is no enforcement mechanism to impose court decisions. In fact, studies show that managers -- to avoid the costs of severance payments imposed by layoffs -- apply wage arrears selectively, concentrating on workers who they view redundant, with the intent to induce their voluntary separation. Other violations of the labor code include non-payments for overtime work and vacations; exposure to hazardous working conditions; and irregularities regarding separation of workers.

The breakdown of meaningful norms is best illustrated by the minimum wage regulations. The issue is not that high inflation has long eroded its value, currently set at 83 rubles, which is less than \$5 (using exchange rate as of mid-November), but that minimum wage regulations are not obeyed, since wage arrears make the real minimum wage a fraction of labor code provisions. In spite of this, the relative incidence of strikes (in terms of days lost in strikes per number of workers) is many times lower in Russia than in countries of OECD. As a sign that workers are increasingly willing to defend their rights, the relative incidence of strikes has been increasing in recent years. While in 1992 only 27 days per 1,000 workers were lost in strikes, the figure rose to 92 days by 1997.

### **POVERTY AND INEQUALITY**

1.6 Poverty in Russia has increased throughout the 1990s. If calculated on the basis of the Russian Longitudinal Monitoring Survey (RLMS), more than one-third of Russian households, comprising some 43% of the population, consumed less than the official subsistence minimum in 1996 (Table 1)<sup>1</sup>. The increase in poverty is a result of a decline in real income, and also of growing inequality in the distribution of income and expenditures. Both the level and growth of income inequality in Russia exceed comparators in transition countries (see Table 2).

1.7 To match the policy orientation of the report, we focus the analysis on extreme poverty—those who live in households where less than 50% of the official subsistence minimum is consumed. To denote those individuals and households we will use the term "very poor". By this stringent measure, 15% of the population were very poor in 1996 (Table 1).

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<sup>1</sup> Alternative quantitative estimates of poverty based on the Russian federation Goskomstat household survey estimates that 21-23 percent of households are receiving average per capita monetary income below subsistence minimum. The Goskomstat survey, however, suffers from sampling problems.

**Table 1. Russia: RLMS-based Extreme Poverty<sup>1/</sup> And Poverty<sup>2/</sup> Measures, 1994-1996**  
(In percent of population/individuals)<sup>3/</sup>

	Extreme 1/ Poverty Rate	Poverty Rate	Poverty Gap (million Rubles)	Poverty Gap (% of GDP)
1994	11.4	37.6	24.6	4
1995	12.9	39.6	27.2	1.7
1996	15.0	43.1	31.1	1.4
In percent of households				
1994	9.4	32.2		
1995	10.4	33.7		
1996	12.5	37.1		

Source: Staff calculations from World Bank version of RLMS data base

1/ Extreme poverty: households with consumption less than 50 percent of the official subsistence minimum.

2/ Poverty: households with consumption less than the official subsistence minimum.

3/ Grossed up to population level by multiplying households times household size in each round. Poverty rate thus measured is higher than on a per household basis because poorer households are larger on average than non-poor households.

1.8 Extreme (and potentially long-term) poverty in Russia is increasingly associated with the following characteristics: residence outside the only growth areas of the country (e.g. outside Moscow/St. Petersburg/Nizhniy Novgorod, the European Russia corridor); low education, entrepreneurial ability or occupational skills; lack of private land or ability to access private land; and unemployment. However, because of pervasive wage arrears and low salaries in some parts of the public sector, extreme poverty is not confined to those without a job. Recent studies indicate a growing incidence of poverty among workers with unpaid wages (Desai and Idson, 1998). The particular vulnerability of children is a matter of increasing concern. Households with a large number of dependents are the most likely to be poor and RLMS data confirm that the birth of a child to a family in "normal circumstances" substantially increases the risk of poverty. Births in 1994 and 1995 were associated with poverty status in 1996. The incidence of poverty among pensioners indicates vulnerability of lonely urban pensioners, most of whom are women.

1.9 The hardship imposed on workers by non-payment of wages has led them to seek secondary paid jobs in the formal sector as well as to engage in informal sector activity. Families have also survived through transfers from friends and relatives, and/or through home production of food both for their own consumption and for sale, using gardening plots. The most extreme poverty is liable to occur in households without the necessary contacts, skills or resources to realize any of these coping strategies.

**Table 2: Russia: Changes In Inequality During The Transition Compared To Other Central And Eastern European Economies**

	Gini Coefficient Income Per Capita	
	1987-88	1993-95
Russia	24	39
Poland	26	28
Hungary	21	23
Estonia	23	35

Source: Milanovic (1998 a, p. 41) and Goskomstat data. Calculated from the countries' household budget surveys (Goskomstat surveys for Russia)

## FAILURE TO REACH THE POOR

1.10 The lack of an effective safety net—one that is responsive to economic crisis and can facilitate restructuring—has limited the ability of the country to deal with growing poverty. A close look at the social assistance system *in a narrow sense*, that is at the system whose specific function is poverty alleviation, illustrates the weakness of the social protection system in reaching the poor<sup>2</sup>. Effective targeting of social assistance depends both on the rules that govern it and on the ability of social assistance offices to implement the rules. In both these respects, several key problems are found with the existing system in Russia.

1.11 First, the Russian social assistance system was originally designed not to alleviate poverty but to provide several small benefits to defined categories of the population, such as the disabled. This categorical approach to allocation of benefits still tends to prevail and excludes many of the new poor, such as large families and the work-capable unemployed. Second, since 1994, social assistance benefits have increasingly not been paid or, if paid at all, have been paid in kind. In a highly decentralized social assistance system, this failure to make payments has reflected both the fiscal squeeze and the collapse of official delivery mechanisms. Third, the overall level of social assistance—amounting to about 4% of the poverty gap in 1994 (Milanovic, 1998 b)—would have been inadequate even with effective targeting. Finally, the performance of the system in targeting benefits to the poorest households has been extremely weak by any standards, including those of other transition economies.

1.12 These deficiencies are documented in the report by Milanovic (1998 b), based on 1993-94 RLMS data. The average benefit per household per month amounted to only about US\$ 5, both for poor and non-poor households. The distribution of social assistance was almost entirely flat, with 13% of the poor and 13% of the non-poor receiving social assistance benefits. The proportion of total social assistance expenditure which went to recipients who should not have qualified on poverty criteria (the “leakage” in monetary terms) amounted to almost two thirds.

1.13 Russia’s social assistance system has been extremely ineffective in reaching the poor, as judged not only by principles of social assistance, but also by the practice of other transition economies (Table 3). In terms of efficiency of the system, only 8% of total social assistance in Russia was distributed to the lowest decile of the population, compared with 20-27% in Poland, Hungary and Bulgaria and 35% in Estonia. Performance in targeting assistance to the poorest households, as measured by the concentration coefficient of social assistance, is also very weak in Russia compared with other transition economies (the more negative the coefficient, the more is social assistance, in absolute terms, targeted towards the poorest households).

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<sup>2</sup> For the purpose of this chapter the definition of social assistance is very rigorous, following Milanovic (1998b). It is any assistance that is left after pensions, child allowances, fuel allowances, housing allowances, unemployment benefits, and student stipends are subtracted. A more widely applied definition would include child, fuel, and housing allowances.



**Table 3: The Performance Of The Social Assistance System In Russia And In Other Transition Economies, 1993-94**

	Effective Percentage of Social Assistance Received by the Lowest Decile	Concentration Coefficient
Russia	8.2	8.2
Hungary	27.2	-25.8
Estonia	34.7	-16.2
Poland	20.5	-19.8
Bulgaria	22.3	-13.8

*Source: Milanovic (1998 b, p. 38).*

1.14 As with social assistance benefits, pensions have also been distributed relatively equally across the population. Nevertheless, the net impact of all public transfers, including child allowances, fuel allowances, student stipends and unemployment benefits, has been somewhat equalizing (Annex Table 10).

### **INFORMAL ECONOMY**

1.15 Informal labor market has played an important role in Russia in 1990s. Its development allowed for a partial offset of the consequences of the income fall. The informal sector helped to develop entrepreneurship, increase employment, and channel resources to more productive activities. The informal sector development ought to be seen as a desirable feature of transition to a market economy. The informal sector increased in all the transition economies in the 1990s (see Table 4).

1.16 However, both the size and the nature of informal arrangements in Russia are a source of concern. The share of the informal activities, as measured by Johnson, Kaufmann and Shleifer had been growing fast and reached almost 42% in 1995 (Table 4). This amounts to a huge revenue loss, since by definition the informal sector does not pay taxes. At the same time in Central and Eastern Europe the initial growth in the share of the informal sector was stabilized and then the informal sector got "formalized" and started paying taxes. The stabilization took place in 1992-1994 when the enterprise reforms began to generate positive microeconomic adjustments as a result of which previously informal activities moved into the formal sector.

1.17 In terms of the nature of the informal sector, the reason for concern is that informal arrangements in Russia can hardly be distinguished from formal ones. State firms are simultaneously engaged in both. Employees are engaged in the informal labor market, while staying on their formal jobs with unpaid, or delayed, wages. This is one of the biggest impediments to the healthy development of the informal sector. Formal and informal sector are not focused on their comparative advantages, and informal sector entrepreneurs do not have incentives to get formalized when they grow in scale. As a consequence, building a modern social protection system is difficult.

**Table 4: Informal Sector in Russia and in Other Transition Economies**

	1989	1990	1991	1992	1993	1994	1995
Czech R	6	6.7	12.9	16.9	16.9	17.6	11.3
Estonia	12	19.9	26.2	25.4	24.1	25.1	11.8
Hungary	27	28	32.9	30.6	28.5	27.7	29
Lithuania	12	11.3	21.8	39.2	31.7	28.7	21.6
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6
<b>Russia</b>	<b>12</b>	<b>14.7</b>	<b>23.5</b>	<b>32.8</b>	<b>36.7</b>	<b>40.3</b>	<b>41.6</b>

*Source: Johnson, Kaufmann, and Shleifer (1997)*

## CHAPTER 2: THE SOCIAL IMPACT OF THE FINANCIAL CRISIS

2.1 The crisis which hit Russia in August 1998 affected first and foremost not the poorest, but bondholders, shareholders, and those who had substantial ruble-denominated savings. The value of all financial instruments tumbled with the Moscow Times dollar index in October 1998 only 25% of its 1994 value. Exchange rate collapsed and ruble lost more than 100% of its dollar value in one month, and almost 200% in the period August 1998- February 1999, when the exchange rate stabilized at the level of about 23 rubles, compared with 7.9 in August 1998.

2.2 However, the crisis spread quickly to wage earners with no or limited savings. Inflation accelerated from 0.2% in July 1998, through 3.7% in August, and almost 40% in September, before it went down to 8.5% in January 1999 and 4.1% in February 1999. The overall consumer price increase between July and December was 77%. Average nominal wage, however, increased by only 26% in the same period, indicating a fall in real wages by about 30% (see Table 5). Minimum wage did not change.

**Table 5: Monthly Trends in Prices, Wages and Exchange Rate July 1998-February 1999**

	July 1998	August 1998	September 1998	October 1998	November 1998	December 1998	January 1999	February 1999
Price change (percent to previous month)	0.2	3.7	38.4	4.5	5.7	11.6	8.5	4.1
Average wage (in rubles)	1,099	1,047	1,098	1,110	1,148	1,390		
Exchange rate (rbl/dol)	6.22	6.78	14.41	15.91	16.45	20.07	22.25	22.90

2.3 This income drop is expected to have lasting consequences. GDP per capita in Russia, which dropped by 4.6% in 1998, as a result of post-August developments, is expected to drop further by 8.3% in 1999 which will lead to a cumulative drop of 13% in 1998-99 (see Annex Table 1). Correspondingly, the beginning of 2000 is expected to be the most difficult period in Russia. Average standards of living will reach the low point, before expected stabilization in 2000 and recovery afterwards. Four aspects are of particular importance: (i) the effect of the GDP fall on the poor, (ii) the possible crisis in food, fuel, and pharmaceuticals provision, and (iii) the possible effect of the GDP fall on social expenditures, and (iv) the role of the informal sector as a cushion to the crisis. Those aspects are examined below.

## EFFECT ON THE POOR

2.4 To assess the impact of the crisis on the poor, the effect of three economic scenarios is simulated under alternate assumptions regarding changes in the distribution of income. In the baseline scenario, the drop in income is assumed to be distributed evenly across all income groups, i.e. no change in income distribution. The second scenario assumes that the decline in income falls disproportionately on the poor (16.8% decline for the poor and 8.4% for the non-poor). In the third scenario, the fall in income has a disproportionately greater impact on the non-poor (15.5% decline for the non-poor and 7.75% for the poor). All the scenarios are static in that it was assumed that households are not able to change their behavior or adapt to the new conditions. This assumption is only tenable for the short run; in the long run, households will adapt and adopt coping behaviors that might lead eventually to improved consumption. The main findings of the analysis for 1998-99 are described below.

2.5 **In the first scenario, where the decline in income is equally distributed, an additional 3.3% of the population would become very poor (additional 6% overall poor), amounting to a 20% increase in extreme poverty** (Table 6). Severe welfare declines can be expected for the poor and especially for the very poor, as falling real incomes combine with failing services and likely worsening social conditions. If it is further assumed that the overall 12% income decline will fall more on those who are just below the poverty line, the number of those extremely poor would increase even more, to 19.4% of the population (a gain of 4.4 percentage points or a 29% increase in the number of the very poor). Even scenarios which are somewhat more favorable to the very poor, where the decline in income falls disproportionately on the non-poor, still result in 17.1% extremely poor—not a great deal better than the baseline scenario of 18.3%..

2.6 **Family composition** of the very poor is not expected to change significantly from the pattern found in 1996. Families with dependents will continue to be much more poor than households without (Annex Table 5). Households with either children or children and elderly comprise more than 75% of the very poor but only 41% of the non-poor.

2.7 **Location.** Locational factors are also fairly constant. Only 3% of the poor live in the major metropolitan areas (Moscow and St. Petersburg), which in turn account for 11-12% of the non-poor (Annex Table 6). The largest groups of poor and non-poor are found in other urban areas (large and small towns). Extreme poverty is more a rural phenomenon, as rural areas account for 27% of the non-poor but 43-44% of the very poor.

2.8 **Children** will continue to account for a disproportionate share of the poor. So many households with children were already poor, before the August financial crisis, that there will not be dramatic increases in head counts for these categories. However, the risk of extreme poverty increases with each subsequent child (unlike when adding elderly members). Furthermore, children face additional problems besides a higher risk of extreme poverty, including the risk of long term or irreversible effects of deficits in early childhood development (see Box 3).

2.9 **Unemployment** will remain strongly associated with poverty (Annex Table 9). In previous research on poverty in Russia, actual unemployment was found to be highly correlated with poverty. Almost one-fourth of households have at least one unemployed in the household.

## Box 2: Children's Vulnerability To Poverty

Overall, children face a risk of poverty which is higher than other social groups, including the elderly. This result should not be surprising, since children are not able to participate in the labor market to earn income, and they do not have stocks of human, physical, and social capital which many of the elderly have accumulated. Information available from 1996 demonstrates that the poverty rate for households with children is much higher than for non-child households, and the probability that the household will become poor if there is an additional child is 13%. This effect of an additional child was the largest in an absolute sense out of all the various factors which were associated with increasing or decreasing the probability that the household was poor. For example, an additional elderly member in the household decreased the chance of the household being poor by 2% (Poverty, 1998).

In the RLMS data base, about 6% of households reported a birth in 1995 and again in 1996. Of the births reported in 1995, 62% of the families with a newborn were poor. This improved somewhat in 1996, when 54% of families with a newborn were poor. Although the number of cases are too low for further statistical analysis, they are suggestive of the shock towards poverty that is associated with a birth.

**Table 6. Russia: Extreme Poverty<sup>1/</sup> Scenarios, 1998-1999**  
(In percent of population/individuals) <sup>2/</sup>

<i>Poverty scenario</i>	<i>Extreme Poverty Rate</i>
Baseline	15.0
Flat 12 Percent Decline	18.3
Poor Lose More	19.4
Rich Lose More	17.1
<u>Memorandum Items</u>	
<i>Percent Change from Baseline</i>	
Flat 12 Percent Decline	22.0
Poor Lose More	29.3
Rich Lose More	14.0

Source: Author calculations from World Bank version of RLMS data base.

1/ Extreme poverty: households with consumption less than 50 percent of the official subsistence minimum

2/ Grossed up to population level by multiplying households times household size in each round. Poverty rate thus measured is higher than on a per household basis because poorer households are larger on average than non-poor households.

## FOOD, FUEL AND PHARMACEUTICALS

**2.10 Food.** The Russian financial crisis has occurred at a time when the Russian harvest is lower than average, and when international commodity prices have fallen relative to peaks in 1996. The low harvest and internal economic disruption have led to concern that poor people in particular regions of Russia may experience hunger this year. In reality, however:

- The harvest shortfall is serious, but not catastrophic. Production estimates are probably biased downward, as producers and surplus regions resort to hoarding. Even if the grain crop is as low as officially estimated (47 million metric tons), food grain needs of approximately 21-25 million metric tons are covered.
- Aggregate supply is sufficient to maintain an average diet comparable to that in many middle income countries. Particular groups, however, are sharply affected by the increase in food prices and by the disruption of traditional patterns of distribution. Affected groups include the politically vocal major cities traditionally dependent on imports, and increasing numbers of the poor

everywhere. The poor in traditional deficit areas will be most affected (Far North, Urals, Far East), since prices there will rise most.

- Targeted assistance to help poor people maintain adequate nutrition is an essential part of the social agenda for the duration of the crisis.
- Low commodity prices have led food producers in major exporting countries (particularly the U.S. and European Union) to lobby successfully for food aid for Russia.

**2.11 Fuel.** The fuel potential problem is a reflection of major issues that the Russian energy sector is facing due to natural monopoly effects, the need to improve the government regulatory framework, and the persistence of non-monetary means of exchange including mutual settlements, monetary surrogates and barter payments. The situation is made particularly acute by the drop in monetary revenues of regional and federal budgets that may lead to interruption in the supply of energy and related supplies of electricity in certain regions. The problem is particularly serious in Russian Northern territories that depend heavily on seasonal shipments during the short months of river and sea navigation. Current and reliable information is not available—the Northern territories are supplied through different channels and a comprehensive assessment is difficult to make. Fuel shortages aggravated by the financial crisis are currently evident in Kamchatka peninsula, which has no local sources of energy. The Ministry of Regional Policies and the Ministry of Emergency Situations has undertaken a tour of potentially vulnerable places, and is planning emergency measures to supply these territories. However, the funding for these activities may prove to be insufficient.

**2.12 Pharmaceuticals.** Three phenomena have occurred since August: (i) sudden increases in drug prices; (ii) shortages in drug supplies in health facilities and retail establishments; and (iii) non-payment of wages to health personnel.

- *Increase in drug prices.* The weakened exchange rate has had a significant impact on drug prices. 65% of drugs sold in the country are imported and 90% of substances used in local manufacturing are also imported. It is difficult to get good estimates of exactly how much prices have increased (there are thousands of drugs on the market and wholesalers and retailers have different pricing strategies in different regions) but all sources of information (the MOH, our contacts in the regions, other donors and NGOs) confirm that price increases have been substantial. These price increases, combined with declining public sector resources and private incomes, have severely limited purchasing capacity in health facilities and for private out-of-pocket purchasing of drugs. There are demand- and supply-side inefficiencies in the drug market that can only be corrected through long-term restructuring measures. In the short run, the most appropriate intervention would be targeted emergency humanitarian assistance (drug supplies) to alleviate the shock and buy time for adjustments in consumption levels and more selective use of drugs.
- *Drug shortages.* There is no generalized country-wide drug emergency today, although there are serious shortages in some regions and for some drugs. That is, drugs are available in the market to those who have the money to buy them. The Ministry of Health estimates that there are 3-4 months' supply of drugs available in local stocks. Initially, there was little movement of stocks due to liquidity problems caused by the banking crisis and accumulated debts to suppliers. While manufacturers and wholesalers used to sell drugs mostly on credit, this practice has been largely replaced by "up-front" cash sales. The situation improved somewhat in mid-September with the stabilization of the ruble at around 15 Rb to the dollar, as funds and drugs started to trickle back into the market. The system will probably continue to struggle on at a "low functional level" for as long as

the exchange rate remains stable. If the exchange rate worsens then drugs may again stop flowing in the market, at least while further adjustments are made.

- *Non-payment of wages.* This problem predated the crisis, but has been exacerbated by more budget shortages.

**Box 3: Magadan and Vorkuta: serious problems but no shortages**

Bank staff visited Magadan and Vorkuta after press reports on food and pharmaceuticals shortages there. Contrary to those reports, supplies of food and medicines are good. In Magadan prices are not administratively controlled. There are 31 suppliers of drugs to the oblast, only 1 of which is a state company, the rest are private and officially licensed. The most pressing social issues are: (i) insufficient provision of food containing vitamins to institutionalized care; (ii) the lack of sufficient financing to provide free drugs to all eligible individuals, and (iii) inability to provide social services to needy people in remote areas. In Vorkuta, there is price regulation of food and medicines. Although there are no shortages, the choice of providers and the selection of goods are more limited.

## SOCIAL EXPENDITURES

2.13 As a result of falling incomes and GDP, social expenditures from the federal and regional budgets are also going to fall in 1999. Given that the revenue drop can reasonably be expected to exceed the income drop, as revenues react more than proportionally to income falls, the effect on social expenditures may be significant. Also, most of social expenditures are financed out of regional and local revenues. While the federal government may have some space for maneuver to offset the effects of the revenue fall, it is unlikely to be the case for subnational governments.

2.14 As a result the largest declines in expenditures in real terms are likely to take place in education, health, and social assistance. In education, the highest reduction would take place in expenditures on general education, which is almost entirely financed out of the regional budgets. For the same reason in health, the brunt of cuts would be borne by primary services. In social assistance, the most affected transfers would be child allowances, that are entirely financed by the regions (even though they are mandated federally). Consequently, the decline in social expenditures in real terms is expected to exceed the 13% income drop, and the share of social expenditures in GDP would fall. Also, transfer payments, often delayed in the past, are likely to remain in arrears, further compromising the effectiveness of the safety net.

2.15 The problem may be aggravated by the Ministry of Finance using budget sequestration. Sequestration has led to particularly sharp cuts in intergovernmental transfers already during 1998, reducing the regional fiscal capacity to support social expenditures. The 1999 budget provides for transfers of 14% of federal tax revenues less customs, but these are highly likely to come under severe pressure in the event of worsening budget performance, much as happened in 1998. Disproportionate cuts in transfers could bring this figure down significantly, and weaken the capacity of transfer dependent regions in particular to provide vital social services. Regions facing severe budget pressures are likely to prioritize payment of the public wage bill at the expense of non-wage inputs to service provision, compromising welfare assistance and quality of education and health care in particular.

2.16 It is important to recognize that the effect of the crisis on social expenditures will be heavily differentiated across regions. The richest regions (13 region-donors) are likely to be able to offset the income drop better than the federal government, while the 15 poorest regions, that depend on federal transfers for more than 50% of their total spending, will be unable to do this at all. Therefore the income and revenue crisis is expected to increase already large income disparities in Russia. The reduced

intergovernmental transfers will disproportionately affect poorer regions. Moreover, intra-regional transfers are also likely to be reduced, which increases the risk to under financing vital social services of local governments (where most provision actually takes place).

2.17 The additional squeeze on expenditures may come from a further increase in informal sector activities and a growth in the barter system, fostering the virtual economy. This was clearly already happening in the first months of crisis (see Box 4). As Gaddy and Ickes (1998ab) point out in a recent paper on the Russian economy, the current system effectively camouflages the existence of value reducing enterprises in the economy, and leads to an equilibrium in which nobody is interested in breaking the virtual cycle. The post-August reality may strengthen those tendencies.

**Box 4: Offsets On The Rise**

On November 20, Reuters reports the case of a friend of a depositor who has frozen deposits in the SBS-Agro Bank. The bank is on the verge of Bankruptcy. The friend has expectation of receiving past wages and needs a car. He strikes a deal with the depositor. The depositor will buy a car from a company that has outstanding debts to the bank. The car company in turn 'pays' the Bank, which credits the account of the depositor. Thus, the friend gets the car, the car company sells its car, the depositor obtains cash against his frozen deposit, and the bank settles its obligations.

## CHAPTER 3: WHAT CAN AND SHOULD BE DONE?

3.1 The crisis should be used as an opportunity to press ahead with necessary reforms. Something can be learned from successes and failures in responding to crises in Latin America and East Asia (see Box 5). Public action can make a difference in the following domains:

- \* the design of economy-wide policies
- \* the policy and institutional framework for labor markets
- \* the creation of a new community-based delivery mechanism of social services and public works
- \* the targeting of social assistance

### **Box 5: What Can Russia Learn From The Experience Elsewhere?**

First and foremost, solving social problems means putting them very high on the agenda; something which has not happened so far in the short history of Russia's transition. The key lesson from other regions is that targeting is crucial and that if government-run schemes cannot target well, there is a lot of merit in setting up special funds. Those special funds, if well-targeted (as in the case of Chile's public works program which set wages low enough to ensure that the most needy were the main participants) have been successful in cushioning the social costs of economic adjustment measures. When the government lacks the cohesion or resources to make a standard social assistance program work, social funds emerge as a very useful alternative. Most of the experience has been in Latin America.

## ECONOMY-WIDE POLICIES

3.2 The sharp drop predicted in domestic demand, approaching 13% in a two-year period, raises the question of whether compensating expansionary policies help the poor. Such policies reduce investor confidence, risk higher inflation, and lower future growth prospects. On the other hand, they can help the poor and may be distributionally favorable if the expansion is moderate and not financed by increased deficit. Lessons can be learned from Latin American and East Asian experience in this regard (see Box 6).



#### Box 6: Could Economy-Wide Policies Help The Poor?

Expansionary policies cannot help the poor if they are financed by an increased deficit that leads to inflation. There is evidence from the Philippines in the early 1980s, and Brazil from 1980 to the early 1990s, that the poor are the hardest hit by high inflation. Although Russia should not aim to keep inflation close to zero, it cannot live successfully with prolonged double-digit inflation. Real exchange rate depreciations will undoubtedly help the poor in the long-run but short-term measures are essential to cushion the effects of price increases. In the Russian circumstances, given that the most severe poverty is rural, real exchange rate devaluation should encourage more labor-intensive investment choices. However, this will come after a period of adjustment. In East Asia, rice farmers in Thailand or smallholder export crop producers in Indonesia are benefiting from real exchange rate depreciation. Financial sector bailouts are also of some relevance in Russia, despite the absence of microcredit and other financial institutions operating in villages, given that Sberbank functions in almost all Russian small towns. There is a lot which needs to be done in the area of institutional transparency and accountability, primarily because there is a major societal concern in Russia about unfair or corrupt gains among the wealthy and connected. However, fostering open and accountable public institutions will take time, because these issues are deeply linked to political structures and therefore not amenable to technocratic solutions.

3.3 The biggest medium-term challenge for economy-wide policies is creating the basis for economic growth. In the short-term, however, the highest priority is to counteract the consequences of the expected massive fall in expenditures on education, health, and social assistance, which are estimated to amount to more than 15% in real terms. These expenditures are the most vulnerable to the crisis since they are financed by regional budgets which are hit particularly heavily by the crisis. In the case of education, it is extremely important to preserve real spending on primary schools, including non-salary spending. This should come from reallocations in regional budgets supported by selective federal interventions, and should be linked to the restructuring of the education sector to eliminate wasteful expenditures. In the health area, a particular challenge is preservation of real spending on health activities with high externalities, such as vaccinations. In the social assistance area, the need for much better targeting of expenditures is more pressing than ever. This will require a significant restructuring of the fragmented system of entitlements that has made targeting so difficult. An overarching rule should be to focus on protection of those expenditures (for example on infant nutrition and vaccinations) which, if neglected, could lead to irreversible declines.

3.4 Financing of expenditures which are absolutely necessary could come from within the social protection system, primarily from turning the untargeted part of subsidies for housing and related utility services into a targeted benefit focused on the poorest. Those subsidies account for about 3.7% of GDP (about 35% of municipal budget expenditures, see Freinkman, 1998). The housing subsidy should be replaced by two categories of expenditures: (i) maintenance of the 1998 GDP share of expenditures on primary education, basic health and social assistance at the same level, which would cost 1.9% of GDP (1% for primary education, 0.6% for health and 0.3% for social assistance); (ii) turning the remainder of 1.8% of GDP into a targeted poverty benefit replacing the array of currently untargeted benefits.

3.5 Increasing disparities are among the key problems of the Russian social protection system. The current fiscal crisis is placing an even greater premium on strengthening federal revenue performance in order to secure a program with the IMF and eventually return to international creditworthiness. The 1999 budget has aimed to reverse the move towards greater regional share of the total public budget but reducing regional tax sharing allocations. The VAT is to move toward 85% federal (from current 75%) this year, and it is proposed to move it to 100% next year. It is highly unlikely that the introduction of new sales taxes and property taxation can compensate for the loss to regional budgets. Moreover, only a small number of regions can presently implement sales taxes, and initial revenue expectations from the new tax are very modest. This implies a shrinking tax base for regional budgets, which may add to the

problem of the regional fiscal base shrinking more than the federal one. The key issue is, therefore, an appropriate use of additional federal resources on the protection of indispensable expenditures on health, education, and social assistance, and on the promotion of targeted benefits.

3.6 The government should use its fiscal leverage to impose conditions on transfers, and force the reform agenda. The most affected regions, however, are the least able to finance additional demands on social spending. They are also likely to be the regions with greatest need-- i.e. highest unemployment, lowest per capita incomes, largest spending arrears relative to GDP, etc. As indicated above, targeting benefits is likely to yield more improvement in the efficiency of social expenditures than any other single fiscal measure. The Russian government is already implementing a program that involves in essence divestiture of housing and social assets by enterprises onto municipal budgets, and implementation of a phased cost recovery program to charge for these services (50% cost recovery for end 1998 was achieved in all but about one dozen regions). In turn municipal governments are working to target assistance to households that cannot afford to pay for higher service charges. Hence, the idea of identifying the 'fat' in the budget to be replaced by additional targeted benefits to avoid negative social consequences of ending subsidies is already there and should be pursued more vigorously.

#### **POLICY AND INSTITUTIONAL FRAMEWORK FOR LABOR MARKET REFORM**

3.7 The experience of successful transition economies shows that the main source of resumption of job creation and economic growth in transition economies is a more productive use of existing resources rather than investment (Buckberg and Pinto, 1997). The reforms should free previously unproductive resources for use in the productive parts of the economy by ceasing to subsidize the preservation of unproductive and often value-decreasing, non-restructured parts. In the case of other transition economies, e.g. Estonia, these steps led to a dramatic simultaneous surge in the job creation and job destruction rates. At the height of the restructuring of the Estonian economy in 1993, two thirds of both separations and accessions were attributable to job destruction and job creation respectively (Haltiwanger and Vodopivec, 1998).

3.8 As indicated in chapter 1, the first step in the process of labor market modernization is doing away with the dominance of insiders among shareholders. Only after this happens, the levels of protection to laid off workers should be increased. Differences in safety net provisions for laid off workers explain much of the difference in experience in labor market restructuring between Central and Eastern Europe on the one hand, and Russia on the other hand.<sup>3</sup> This should take either the form of increased unemployment benefits, provided federally, or special federal severance pay schemes focused on enterprises being restructured or closed down.

3.9 **Legal framework.** The legal system in the Russian economy is very limited in its ability to enforce the law. As such, reform of labor legislation is not the solution to the immediate problem. However, work on reforming the labor code, which essentially remains identical to the 1971 code (with

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<sup>3</sup> This observation was made by Blanchard, 1997. In this study we are trying not to overemphasize the safety net factor by stressing that the hard budget constraint has to come first or together with the improved safety net. When the hard budget constraint is present it is possible to invoke labor market restructuring even in absence of improved provisions for the unemployed, as the example of Estonia shows. However, Estonia's privatization was not insider privatization. On the other hand, when there is insider privatization present, or trade unions are powerful, it seems extremely difficult to impose hard budget constraints without corresponding improvements in unemployment benefits/severance pay arrangements, as examples from Central and Eastern Europe show.

some revisions in 1992) is very important as it lays the groundwork for, and helps facilitate, the eventual introduction of a market economy, and well-regulated market enforcement mechanisms.

3.10 The new labor code should pay particular attention to facilitating restructuring of enterprises by promoting job creation through reducing the costs of hiring and firing workers. For hiring policies, it will be important to reduce excessive benefits associated with employment, as well as to eliminate current restrictions on the use of fixed-term employment. The law need not define the conditions for fixed-term work, nor prescribe the duration and maximum number of successive contracts. To facilitate layoffs and firings, and therefore to stimulate new hires, the labor code should ease the conditions on firing, such as use of current vacancies for re-hiring the worker if his/her current job is no longer required, or the current requirement for sign off by trade unions.

3.11 *Unemployment benefits/severance pay.* As indicated earlier, the current system of unemployment benefits is inappropriate in several respects. First, the system fails to protect workers adequately from falling into poverty on separation from employment. The average unemployment benefit is currently only about 25% of the average wage, and it is uncertain whether there are enough resources to pay it. In fact, payment of the benefit is often in kind. Moreover, the benefit is not indexed to account for inflation, and the minimum amount is far too low—set at the minimum wage, which is currently 83 rubles (or less than \$5). Second, the current system is inconsistent as it mixes the principle of insurance with the principle of poverty alleviation. By extending the benefit to first-time job seekers, re-entrants to the labor market, and some other workers with no or no immediate previous history of insurance contributions (although at a very low level, currently less than 10 percent of the average wage), the system works as a quasi social assistance program. Exhausters of the benefit are also eligible for the minimum benefit after a waiting period of six months. Last but not least, the current system allows for huge interregional differentials, as 80% of Employment Fund revenues are retained in the regions. As a result some regions do not have resources to pay benefits, while others have resources for capital construction.

3.12 Under the current circumstances, the function of the unemployment benefit system should be strengthened and the system itself significantly simplified by *the introduction of a flat-rate benefit*. This benefit would be available only to those workers with immediate previous work history while paying contributions to the employment fund. While in the immediate future its level would have to be determined by the availability of resources, in the longer term the government must strive to raise it above the subsistence level. Employment Fund should be centralized to allow for redistribution to poorer regions.

3.13 Severance pay requires special attention by the government. The current legal provisions are often not fulfilled since enterprises do not have the liquidity to finance due severance. However, from the point of view of the reformist government, offering an administratively simple and adequate compensation package may be the right way to facilitate genuine enterprise restructuring, that is, to make a once-and-for-all expenditure with potentially very high returns. At the same time, there is no doubt that typically the scale of compensation payments required for a large enterprise restructuring and divestiture program lies beyond what can be afforded from regional budgets. Therefore, there is a strong case for the federal government to step in and offer attractive packages to reformist regional governors.

3.14 *Labor market interventions.* In Russia's circumstances it is very difficult to use labor market interventions to promote enterprise restructuring and job creation. Some measures that are viewed favorably in developed economies—for example, wage and hiring subsidies, particularly for low-skill workers—may provoke manipulation and strategic behavior on the part of enterprises and are thus deemed inappropriate. The presence of soft budget constraints impedes efficient reallocation of labor also by

affecting hiring decisions. Enterprises with little chances of survival—but protected by the government from undergoing bankruptcy—may bid away workers who would otherwise accept jobs in more prosperous enterprises. That is, even if programs do succeed in putting workers to jobs, it is not clear, given the prevalence of labor hoarding, that the new jobs would constitute a true job creation and increase efficiency of labor allocation (the same problem existed also under the socialist system). It is also highly unlikely that the effectiveness of labor allocation would be promoted through programs to stimulate labor shedding by financing the separation costs of enterprises. Under the current incentives, there is even no guarantee that after separation the workers are not rehired by the same enterprise.

3.15 Programs that are worth supporting under present circumstances are those *that create jobs in a more direct and controllable manner*, such as public works. Because they can combine the provision of work opportunity to the poor with key basic maintenance and rehabilitation investments, public works programs suit best the purpose of the project currently under consideration. However, they should also be selected on the basis of high rate of return.

### FIGHTING SOCIAL EXCLUSION

3.16 One of the burning issues the government needs to address in the more general framework of social policy development is how to improve the efficiency, coverage and impact of programs to address the needs of those specific groups of the population most vulnerable to social exclusion and to confront major problems related to their integration in society. In particular, the country has to review, restructure or design social programs dealing with orphaned children (especially those who are in institutions), children from dysfunctional families, street children, children with special needs, single (isolated) elderly unable to take care of themselves, and the homeless. These groups have different needs and the hardship of transition affects them differently, so they require different type of services and other assistance. Nevertheless, they have one thing in common: *isolation from the society and exclusion from most of the existing social programs or safety nets*. Both public social services and non-governmental assistance can play important roles in design and provision of various types of assistance to these groups.

3.17 Many of the problems related to social exclusion can only be resolved with an improvement of the overall economic situation. Meanwhile, increased attention should be given to the current situation in trying to reduce the risk of more children being abandoned or ending up in the street, to prevent further disintegration of society with the growth of crime originating from these social phenomena, and to improve the existing programs dealing with socially dislocated groups. In this area, communities and local social workers should play the most important role and their efforts should be supported, leading to decentralization of social services and increase of the community role in outreach to the most needy. Among socially excluded groups the situation with children is of particular concern.

3.18 **Street children.** The government has made support to street children (estimates vary between one and four million children occasionally or permanently living in the streets) a key focus of the social component of its new program. The phenomenon of street children is directly related to the social stress experienced by Russian society during the transition and it is expected that the situation will worsen with the additional fall in living standards due to the financial crisis. Many factors can explain this growing phenomenon: increase in rates of divorce, alcoholism, households falling into deep poverty, inflow of refugees from CIS countries and southern regions of Russia, sometimes the poor state of some boarding institutions for orphans or abused children.

3.19 Street children are difficult to integrate in formal programs. Recent studies suggest that they come often from other CIS countries, are concentrated in big cities, and are usually asked by their

families to beg for food and money. Some street children have run away from abusive homes and are being exploited by adults. Experience in other countries shows that abuse of such children is often related to exploitation for prostitution and theft. To cope with this harsh reality, children may end up using drugs, and selling them to be able to sustain the habit.

3.20 It is a very complex problem and programs should be developed towards very open forms of temporary support provided to street children who participate voluntarily, for example, shelters where children can come and go, and canteens serving hot meals for street children. As they are also liable to have severe attachment disorders and post-traumatic disorders, psychological and emotional support may be equally important.

3.21 ***Children in institutions.*** Permanent residential institutions should be the exception and last resort for dealing with the problem of orphaned, neglected or abused children. It is difficult to reintegrate in society a child who comes out of a residential institution. Often, children who spend a long time in an institution lack the basic emotional care and security needed, resulting in developmental delays. On social and humanitarian grounds, therefore, institutional care should be considered only as a last resort. It is also very expensive. Incentives should therefore be given to communities (i) to reintegrate these children in society through alternative family care (adoption, foster parental care or through special programs to support relatives or biological parents of the children), as well as (ii) to carry out preventative work addressing the root of the problems—dysfunctional families and families in crisis—and aiming to reduce the number of abandoned, orphaned and neglected children.

3.22 Dealing with these issues will require reorientation of the current system into support for families rather than a “saving the children by the state” approach, and building a coherent strategy for child care, covering adequate medical and psychological treatment of children according to their needs, support to poor and dysfunctional families, family and child/teenager counseling, finding families for children and development of alternative family care models.

3.23 ***Children with special needs.*** The Russian society needs a major transformation to accept such children (and adults), to allow them to integrate fully and to have enriched lives. Such work requires a complex approach covering development of a coherent policy, major investments in infrastructure and equipment, serious changes in mentality and attitude, large-scale education and information work, changes of health care and education systems leading to individualization of their approach to children, and development of corrective individual training plans. This cannot be done quickly. There are, however, at least three main lines along which initial efforts should be oriented: (i) mainstreaming children with special needs into local schools and improving their access to the social infrastructure available for ordinary people, (ii) increasing public awareness of their needs and ways to treat them with respect, understanding and kindness; (iii) educating and training parents in keeping children with special needs within a family context and giving the child the warmth and security he needs to develop a normal life. This approach will help to integrate such children in the society.

3.24 ***Early child nutrition and infants in orphanages.*** The danger of child malnutrition in the poorest multi-children families will inevitably increase under the post-crisis conditions, underlining the crucial need to target assistance to such families. There is no indication at this stage that operation of the milk kitchens, where mothers get free or heavily subsidized milk and dairy products for children under two, has yet been significantly affected—neither the Ministry of Health nor the Association of Milk Kitchens are aware of any crisis impact. The kitchens still function all over the country and provide limited amounts of products, although they have received no funds from the federal budget since 1996 and their significance for many mothers seems to be diminishing. The growing number of infants in baby orphanages, who are the responsibility of the public budget and cannot be breastfed, are a particular

source of concern. Although this situation has not yet been affected by the crisis, it could well be in the future: (i) the share of children under one year old in the baby orphanages (with infants up to the age of three) has increased dramatically in the last few years, from about 15-20% to 40-50%; and (ii) the resulting increase in their requirements for baby food, combined with the rise in import prices, will be difficult to support under the tightening budget constraints of the orphanages. These are priority areas for careful monitoring. Support to Russian baby food producers or to imports would not provide a solution for the poorest families or for baby orphanages. What is called for is early action to support the incomes of the neediest mothers, through effective targeting of assistance, minimizing the number of infants for whom the state needs to take responsibility.

**3.25 *Isolated elderly and disabled.*** The single elderly are found among the groups most vulnerable to poverty. Capacity to take care of their everyday needs is decreasing with age and aggravating diseases and, being alone, they fully depend on formal safety nets. In most cases, their survival challenge is not the shortage of income per se, but limited ability to move and to receive external support resulting in lack of access to medical, social and other services, difficulties in obtaining food or pharmaceuticals, entire marginalization from the society. The evidence suggests that none of the existing programs initiated by either social offices or non-governmental organizations reach these isolated people adequately and provide services according to their need. The public programs include local day-care centers for the single elderly and disabled, organized by social workers, and specific services provided sporadically (cleaning, food and drug purchase, settling obligatory payments, etc.) by free-lance social workers. Such programs should be supported and expanded, with specific attention given to lessons of experience such as success and failure in reaching socially isolated elderly and disabled. One of the challenging issues to resolve is how to identify these people and help them to reintegrate into the society. Club work, day care, information dissemination, specific actions undertaken in large and fairly disintegrated communities (bit cities) should be designed in order to help identify socially excluded people, their needs and ways to bring them back to a decent existence.

**3.26** Programs should be designed in a way that would strengthen social capital and help Russia to strengthen civil society. This would entail giving additional responsibilities to local level organizations and communities to take on the delivery of social programs, increasing the participation of communities and beneficiaries in decision making and monitoring of social programs, and providing incentives to families and local groups to take responsibility for helping socially vulnerable groups.

#### **GIVING A STRONGER ROLE TO NON-GOVERNMENTAL ORGANIZATIONS (NGOs)**

**3.27** Close collaboration with NGOs in designing the response to the social impact of the financial crisis and in fighting social exclusion should be high on the government's priority list. NGOs are still relatively new in Russia and very few are active in the social assistance area at the federation level. The Red Cross is probably one exception and it is mostly active in delivering humanitarian assistance programs. At the local level, however, some NGOs are quite active in the delivery of programs or as lobbies to ensure that support is provided to their constituents. Examples of powerful NGOs are the association of war veterans or the association of mothers of soldiers. The Russian Orthodox Church, which has a fast growing network of parishes, still has a relatively small role in delivering programs to the poor, aside from limited charitable activities connected to the church parishes. Although the church has limited experience in this field, it is a potentially important stakeholder in the medium to long term.

**3.28** Capacity building of local NGOs to support delivery of social programs to the vulnerable groups as well as in supporting the self employed and small enterprises is essential to support decentralization of social services and increasing outreach. Some local NGOs are increasingly involved in delivering

programs to highly vulnerable groups such as street children and disabled but they generally have little capacity and sometimes face a hostile attitude from local governments. There is evidence also that many new NGOs are being created with the purpose of accessing donor funds despite weak program proposals and no experience. Careful screening of NGOs is therefore needed before they can be funded. A number of international NGOs have developed very interesting programs to strengthen capacity of NGOs, such as the Eurasia Foundation and Open Society Institute which provide technical support and sub-grants on a competitive basis to local NGOs. Through these initiatives, networks of NGOs have been created such as the Siberian Civic Initiative, particularly active in Vladivostok, and networks in Novgorod and Moscow.

### NEW DELIVERY MECHANISMS FOR COMMUNITY BASED SOCIAL PROGRAMS

3.29 Existing mechanisms for delivery of social services and social support to the poor in the Russian federation have a number of limitations. They lack the capacity to target the most needy: with very few exceptions, the regions do not have reliable mechanisms to ensure that cash benefit or humanitarian assistance is delivered to the most needy among the population. Also, no mechanisms exist to weight fiscal transfers from the Federation according to poverty levels or social needs criteria. This is a major shortcoming that seriously limits the efficiency of public expenditures in the social sphere. The federation also lacks mechanisms to act rapidly, efficiently, and in accountable way, to support areas at the sub regional level that are experiencing temporary serious social problems.

3.30 With a few exceptions, collaboration between the various agencies that are active at the local level is poor. Lack of information to beneficiaries and of participation of different stakeholders in design and monitoring of programs, often results in lack of accountability and poor performance. It is very important to encourage a broader participation of citizens and institutions which are close to the population in the design and implementation of social support programs.

3.31 It seems therefore important to support the design of mechanisms that would have the following characteristics: (i) favor a clear sharing of responsibility between the federation, the regions and the local level structures (raion, municipalities, NGOs); (ii) encourage the participation of the population and local level institutions in the delivery of services; (iii) integrate specific instruments to ensure adequate control and accountability in the use of funds, and to channel funds rapidly to finance visible activities that help the poor and vulnerable groups. A *social fund type mechanism* which has been implemented successfully in some former Soviet republics, could help in achieving the above mentioned goals (see Annex 2 for a detailed proposal).

3.32 The social fund should have the following specific design features. It should receive proposals prepared by local governments, NGOs and local associations. Its staff would evaluate these proposals according to pre-defined criteria clearly stated in an operational manual. Approval of individual appraised proposals would be made by committees set-up at the local level with representatives of different stakeholders. The social fund would integrate a Management Information System designed to track all expenditures and physical progress of individual projects. Its activities would be overseen by a Board set up at the central level. Some of these mechanisms have already been tested recently in the framework of the coal restructuring projects and have worked well in the support of social programs.

3.33 The social fund-type mechanism finance may also finance labor intensive public works that are identified by municipalities, local associations, NGOs or local administrations, for the rehabilitation of local infrastructure, including sanitation systems, schools rehabilitation, road maintenance, etc. The social-fund mechanism could also be used as a tool to address some of the problems of socially excluded groups, including support programs for street children, pensioners living alone and the handicapped

outside institutions. The social fund-mechanism would offer choices and provide criteria for selecting the priority activities.

### IMPROVED TARGETING

3.34 With sharply tighter budget constraints and an increased number of people in need, the financial crisis has made targeting even more important than before. The country faces a challenge with cost recovery in many major sectors, including housing, energy, communications and utilities. Two kinds of transfers are involved: general cross-subsidies which are given to all (for example, the price of the metro in Moscow is low for everyone); and numerous special benefits (*l'goty*) which are given to privileged groups such as the elderly, veterans, people who work in certain occupations, etc. While indeed some of these groups may be poor, there is clear evidence that the vast majority are not.

3.35 One of the real challenges of determining who is poor in Russia is the fact that money income is not a good indicator of household welfare or poverty. First, many households are paid in kind instead of cash; and in either case the payments are erratic. Second, much of household real consumption is obtained from the labor and assets of the household itself, or of other households. The most important example is that of the private plot, whereby many households obtain a good portion, the majority, or nearly all of their food consumption. Third, households benefit from gifts of food or goods from other related or non-related households; these gifts are often consumed immediately. Such inter-household transfers can play an important role in keeping some kinds of households, such as single parent households, either out of poverty, or in less severe poverty. Fourth, households also tend to under-report (hide or conceal) their true income, to both social workers and to survey interviewers, in all countries. Means-testing (determined household income and wealth) is quite expensive even in countries with advanced tax reporting systems, but is prohibitively expensive in a country like Russia where individuals do not perceive the need to fully disclose their informal earnings and where they may indeed be frightened to do so, for fear of loss of privileges, rent-seeking on the part of official contacts, or violence on the part of "business associates." Finally, while household consumption is less prone to under-reporting than income and is a much better guide to household welfare, it takes considerable time and effort to collect detailed information on household consumption from household surveys. Trying to do so as an eligibility criteria for receiving social assistance would be even more costly than income- or means-testing. (Plus households would quickly learn to under-state their expenditures just as some currently under-state their incomes).

3.36 Several alternatives to fully documenting every household's income and expenditure that are also better than the previous outdated categorical approach, have been introduced experimentally in three social assistance pilots in the Komi Republic, and in Volgograd and Voronezh oblasts. Each of the three pilot methodologies tries to estimate the additional amount of consumption that a hypothetical household could achieve, and to use this estimated household consumption to determine eligibility (Box 7).



#### Box 7: The Targeting Pilots

The three social assistance pilots were designed to identify the poorest of the poor, and to transfer a modest cash benefit to them. Identification of the poorest was based on estimating the potential consumption of families based on their measurable characteristics. Households were awarded benefits if their estimated per capita consumption was below 35 percent of the per capita subsistence minimum in Komi, and below 50 percent in Voronezh and Volgograd. Three different approaches were used. In Komi, households were said to be judged based on "economic potential" of the family. The methodology imputed the worth of a private plot, rental of "above-norm" space, and use of a private automobile--the latter two, to estimate informal income, the first to estimate income in kind. The approach in Voronezh was a refinement of the traditional categorical approach to determining "need," with the benefit made available only to certain kinds of people thought *a priori* to be poor (many-child households, single mothers, single pensioners, disabled). An addition to the traditional categories was made by the inclusion of families with children who could show wage arrears of more than 3 months and the unemployed. Also, actual (not assigned) money income was calculated along with income from land and livestock. The approach in Volgograd was two-fold, as the oblast was asked to pilot the approach most foreign to Russia--a proxy means test<sup>4</sup>--in three raions. The rest of the oblast was left to its traditional categorical-only approach. Preliminary results suggested that this approach is similar to Voronezh in that both provide better targeting outcomes than the outmoded traditional categorical approach.

3.37 Several lessons can be drawn from the successful implementation of the three different targeting systems in three very different oblasts of Russia:

- ◆ *Targeting is feasible.* All the methodologies relied on some estimate of "economic potential" "total potential income" or "potential consumption" of the applicants to avoid reliance on statutory (naschislenny) income (which would lead to highly distortionary outcomes in a country where wages and transfers are often not paid on time and where individuals may under-report income because of tax considerations).
- ◆ *Targeting can be effective.* Oblasts which have introduced targeting report a higher degree of social consensus and a much increased ability for the authorities to help those who are truly needy.
- ◆ *Benefits should be paid in cash wherever possible.* Countless respondents and social workers have informed the mission during its many visits that the provision of a timely benefit in cash was crucial for families to resolve problems such as immediate need for food, for transportation to search work, or for the purchase of medication or school supplies. No system could have identified all these individual needs and met them successfully through any sort of mechanism for distribution of in-kind items.
- ◆ *Computerization and training promote the effectiveness of social workers.* Automation allowed the social worker more time with the client. Also, the special trainings that were conducted by the oblast authorities on the goal of means-testing, led to a greater degree of satisfaction and effectiveness on the part of the social workers.
- ◆ *Transparency is extremely important.* In the three areas, the pilot program was widely publicized in the press, on radio and also on posters displayed at local social assistance offices.

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<sup>4</sup> A proxy means test is a formula calculated from regression coefficients, when actual consumption is regressed on correlates of consumption (or its opposite, poverty). The formula can be then used to predict consumption of households from the regressor variables, such as wage income received, number of members of the household, presence of a car, etc.

Additionally, given that the rules were usually clear, the social worker was freed to concentrate on only those extreme and unusual cases that did not fit the profile. In such cases, or in the event of client dissatisfaction, the case was referred to a “conciliation commission.” If the commission found that the circumstances were indeed meritorious, then the oblasts used other kinds of help for the client (often the “one-time assistance.”). This meant that over all, there was a feeling of social fairness associated with the pilot benefits.

- ◆ *Errors of exclusion can be minimized.* The mechanism of the conciliation commission demonstrated that it is possible to minimize errors of exclusion in any methodology. Unfortunately, many people when they first think of social assistance think of keeping undeserving people out (avoiding the inclusion of the non-poor). While it is usually possible to construct an expensive system of supervision that minimizes errors of inclusion, such systems do not perform well in what should be the primary goal of any social assistance program--reaching the poor or reaching the poorest of the poor. The pilots were designed to reach the poorest of the poor (given the fiscal constraints of both the federal and local governments) and preliminary evidence suggests that this goal was achieved. In particular, the conciliation committee was an “escape hatch” for those few cases that were deemed needy by the oblast but did not meet the selection criteria of the methodology.
- ◆ *Targeting should not be confined to experimental benefits.* Targeting can be used extremely effectively towards targeting any benefit, whether in cash or in kind. The introduction of targeting eliminates the old categorical approach which excludes the new poor, especially families with children and the unemployed. Before the introduction of the pilot benefit in the three oblasts, local authorities were limited to helping such families only by the so-called “one-time assistance” which was often not enough to bring the families out of poverty. By eliminating allocation of benefits to the old privileged categories, resources could be freed to target the poorest of the poor.

## MONITORING OF TARGETING

3.38 Monitoring of targeting and social assistance is an important aspect of overall effectiveness. The social assistance pilots included several different kinds of monitoring:

- monitoring of the quality of work of social workers
- monitoring of finances from central and local sources
- mid-term course correction for methodologies
- monitoring of administrative costs
- planned monitoring of beneficiaries and those who did not receive benefits
- monitoring of actual pilot outcomes (survey)
- monitoring of particularly vulnerable groups, such as children in danger of being malnourished or institutionalized.

3.39 Ideally, one management information system (MIS) would be set up within the Ministry of Labor and Social Development (MLSD) to perform these monitoring functions. As it is currently, the MLSD is often not informed by the regions of developments in a timely fashion.

## FOOD, FUEL AND PHARMACEUTICALS EMERGENCY ASSISTANCE

3.40 **Food.** Large scale food aid is not likely to be an appropriate instrument for addressing the particular needs of vulnerable groups and regions. Past experience with food aid in Russia (1991-93) indicates that targeting is approximate at best, and dangers of diversion and corruption are high. Food aid sold on open markets depresses incentives for domestic producers, and does little to help genuinely needy consumers. Government management of counterpart funds, even when they flow as intended to the budget, may not be adequate to direct these resources to the intended targeted interventions in the social sphere. Agricultural interests within Russia may exert pressures to use counterpart funds instead for centralized investments in favored activities of questionable long-term viability. The proceeds from already granted aid from USAID (US\$ 600 billion) and the expected aid from the EU should be distributed to the population using targeting mechanisms such as the ones described above.

3.41 **Fuel.** The fuel situation in the North is more serious than the food situation. The preliminary assessment of the overall situation was that the European North (Murmansk, Archangelsk, Komi, and Nenets) would be in better position should emergency measures need to be taken because of the easier transport access to those regions. Finland and Norway have been offering aid in the form of food and fuel to its neighbors on the Kola Peninsula. Alaska had delivered 20,000 tons to its neighboring Arctic littoral, Chukotka.

3.42 **Pharmaceuticals.** Additional needs are related not to a shortage of pharmaceuticals, but to the problem of a steep increase in pharmaceuticals' prices as a result of exchange rate movements, when 60% of drugs are imported and most of the others are made of foreign components. The needs are estimated at \$60 to 100 million.

## BANK'S ASSISTANCE

### Box 8: Current Lending Activities Of The Bank In Social Sectors

The World Bank has an extensive program of assistance to Russia's social sectors. It addresses many of the gaps or emerging problems that are being exacerbated by the crisis, as well as longer term structural reforms in social protection and social services.

Projects under implementation or preparation:

- Social Protection Adjustment Loan (SPAL) - the SPAL, together with a related technical assistance loan - the Social Protection Implementation Loan (SPIL), described below, form the operational framework for Bank advice and lending in social protection. The SPAL supports strategies aimed at providing Russia with a social safety net that provides protection to the poor and vulnerable groups for the transition and beyond. It focuses on the pension system (minimum pensions, short-term stability of the Pension Fund, and systemic pension reform), employment and labor market policy (unemployment benefits, active programs, labor code), child allowances (transition from a universal to a targeted benefit, institutional strengthening), rationalization of short term benefits (sick pay, maternity benefits) and social assistance (better targeting). The first and second tranche conditions of the adjustment loan have been met. Following a government request to redesign the third tranche of the SPAL, changes were introduced to the program. The changes maintain the directions of reform of the social protection system that formed the basis for the SPAL, while introduce a program of actions that will strengthen the reforms and take into account the constraints imposed by the current economic and financial circumstances.
- Social Protection Implementation Loan (SPIL) - this technical assistance/investment companion of the SPAL, is aimed at supporting the design and implementation of policies introduced under the SPAL, as well as flexibly addressing design and implementation of related issues in social protection. A number of ongoing activities under this project directly address the fallout from the crisis: (1) monitoring of vulnerable groups and the impact of social programs aimed at such groups; (2) examining the scope for rationalization of poverty benefits; and (3) review of programs for the long term unemployed.
- Employment Services and Social Protection Project - this project is piloting ways to strengthen delivery of active employment programs (counseling, assessment, provision of occupational information), and it is providing equipment to speed up the delivery of pension payments (it has reduced waiting times from an average of two weeks to two days). Recently, the government has requested that the project should pilot community development programs to stimulate employment, and such a component is in the process of being introduced into the project. Such pilots would subsequently be expanded
- Pension Support Project (1999) - a new investment project under preparation and with strong ownership on the Russian side, aims at improving efficiency of the pension administration and at the introduction of individual worker accounts. It would also begin to address the institutional changes that will be necessary for the introduction of the government's reform of the public pension system.
- Northern Migration Pilot Project At the request of the Russian government, a project is under preparation to develop incentive-based public migration assistance schemes that will encourage voluntary migration from settlements in the Russian Far North. It is expected that the schemes subsequently would be adopted more generally to promote migration in support of the government's Northern restructuring policy, which aims at making Northern development self-sustaining, reducing the need for public subsidies and northern-specific transfers from the federal budget.
- Medical Equipment Project - This project is supplying badly needed medical equipment to primary and secondary level facilities. The government may request the Bank to allocate some of the funds under the project for emergency drug purchases.
- Health Reform Pilot Project - Approaches to longer-term restructuring at the oblast level are being tried out in this project. Implementation has just started and should continue as planned. Early findings are being used to design national level reforms under the proposed Health Reform Implementation Project.
- Health Reform Implementation Project - This project (under preparation for FY00) will address longer-term restructuring issues from the national perspective and build Ministry of Health's capacity to lead the reforms in partnership with regions.
- Education Innovation Project (1997) - this project aims at improving the quality and provision of textbooks to secondary schools. It does so through support for developing new curricula and improving the approval mechanism for new textbooks. In higher education, it is establishing a fund to promote innovative approaches to development of social sciences and governance reform.
- Education Restructuring Project (1999) - will address structural problems as well as regional autonomy issues. It addresses longer-term issues of education finance, and it also aims at reform in testing and assessment, curriculum development and teacher training, school administration. It will test solutions to these issues by means of pilots in selected regions.

3.43 Box 8 describes the Bank's existing assistance in the social sectors. As a result of the crisis, a new operation, the **Local Social Protection Delivery** is being discussed with the government. The proposed project would aim at mitigating the social impact of the financial crisis.

3.44 The operation would consist of two components. The first component would focus on *targeting*. It would help to expand the pilot experiment started under the SPAL in three regions and allow the government and regions to improve targeting of cash benefit programs and humanitarian assistance. The component would also support continuing improvement of the monitoring system to help identification of regions and areas in special need of support. There are conceptually two stages to this effort—rapid response and longer-term development. The rapid response would focus on selected oblasts where locally financed social assistance is already provided through some sort of targeting mechanism. A team of Russian and World Bank experts would assess the existing methodologies and recommend changes in order to implement a strong system of monitoring of targeting on the local level, with central and local reporting. The rapid response would quickly help capable oblasts to target more efficiently, and serve as a demonstration for the rest of the country which would be covered in a longer-term investment project. Longer-term development would gradually expand the targeting program nationwide.

3.45 The second component would help to set up a new delivery mechanism for social assistance and social services in the form of a Community Solidarity Fund. This Fund would finance programs targeted at the poor and vulnerable groups and implemented by institutions active at the community level (raion and village councils, small town municipalities, local associations). The Fund would support three programs:

- (i) labor intensive public works to support rehabilitation of basic infrastructure useful for local communities and create temporary employment for long term unemployed and workers who are not paid any wages;
- (ii) support, on a competitive basis, of local institutions to provide care to street children and isolated elderly and help in their integration in society;
- (iii) pilot community improvement programs that would help poor and isolated villages and small town to undertake small projects to improve delivery of social services to community members. The details are described in Annex 3.

3.46 **Labor market review.** In order to provide the Bank and the government with a solid basis for realistic policy-related advice and project work in the labor and employment area, in the crisis circumstances, the Bank needs to undertake a review that will assess current labor market policies, investigate the nature of Russian labor markets, and evaluate current activities in the employment area. This will result in a World Bank sector review. (Similar ones have been done in poverty and for social protection.) The work would be undertaken through a series of missions and in collaboration with Russian authorities and individual experts. It would draw on disparate studies and surveys – Russian and other - that are ongoing. We expect to complete it in mid-1999. We shall be seeking the support and advice of the Ministry of Labor and Social Development in this activity.

3.47 At the same time the existing operations would have to be modified or restructured to take into account new post-crisis realities.

3.48 **Social Protection Adjustment Loan (SPAL).** The constraints imposed by the current crisis made it unlikely that third tranche conditions could be fully met without waivers on some conditions and significant delays in the fulfillment of others. In this situation, the SPAL third tranche has been

restructured with a view to introducing conditionalities that take into account new crisis developments, and that are implementable under the current situation, as well as monitorable. Some of the new SPAL conditionalities have, *inter alia*, to be directly linked to the issues of targeting and delivery mechanisms that are to be covered by the Local Social Protection Delivery Project

**3.49 Social Protection Implementation Loan (SPIL).** The SPIL is expected to continue as its activities in fact extend beyond the confines of the SPAL. It also offers the opportunity of flexible adaptation to emerging needs, as long as they stay within the original framework of the SPIL objectives. Currently, SPIL also has ongoing activities that address the fallout of the crisis, such as developing programs for the long term unemployed, and developing poverty and standards of living monitoring and survey capacity. All respond to the crisis and are well under implementation. Accelerating those actions, and making sure that implementation occurs successfully, should be the priority.

**3.50 Structural Adjustment Loan (SAL 3).** The social protection agenda pursued in the context of the SPAL and the SPIL is being supported and further developed under SAL 3. That loan, which is currently being discussed with the Government, is expected to include conditionalities related to strategic issues on employment and social insurance, as well as federal-fiscal relations. In employment, changes in the labor code will make it more market-oriented, with better income and employment opportunities for workers and more efficient functioning of commercial enterprises. In social insurance, conditionality aims at focusing social insurance on essential services (sick pay, maternity benefits), and on removing distortions in the current system for provision of sick pay. This is expected to improve efficiency in the use of resources in this area, and allow reduction in the payroll tax for social insurance. Moreover, that SAL is expected to improve transparency in federal-regional fiscal relations, which will allow for better management of resources going to the regions and at regional levels, including for poverty alleviation.

**3.51 Child welfare (institutionalized children).** The Bank has recently undertaken a review of the institutionalization of children with the support of the Ministries of Labor and Social Development, Education and Health. A report is under preparation. Based on the report's findings and forthcoming discussions with the Russian government, we expect to reach an agreement on strategic measures in the area of child care reform, addressing, in particular, options for deinstitutionalization and restructuring of child care, development of alternative family systems, support for families in crisis, development of alternative small-scale forms of institutionalized care for unavoidable cases, provision of diverse effective social services to children at risk in the situation of tight budget constraints, mainstreaming of children in institutions. We expect that this will lead to a future project or project component.

**3.52 Pharmaceuticals.** While it would be possible to provide temporary financial support to publicly-owned health facilities to mitigate the shock of price increases, such assistance would do little to solve the long-term structural problems related to improper selection and use of drugs, inefficient market distribution mechanisms, and inappropriate pricing policies which, besides the lack of money, are the fundamental causes of drugs shortages. In addition, such assistance could cover only inpatient drugs, which are given free-of-charge in hospital facilities. Because outpatient drugs are purchased directly by patients through retail pharmacies, targeting emergency assistance for outpatient drugs would be difficult at best. Preferential support for inpatient drugs would, in turn, exacerbate the distortionary incentives already present in the health system to overuse inpatient services, and unnecessarily increase the costs of the health system. The long-term structural reform of the health system planned under the proposed Health Reform Implementation Project would be the more appropriate response to funding shortages in health and eventually to reducing drug shortages.

**3.53 Severance pay.** While there is a strong case to finance severance pay for enterprise reform programs supported by reformist regional governors, the federal government is unlikely to have resources

to finance those programs. Therefore, there is a case for the World Bank to consider the provision of resources for severance pay, at a given point in time, to remove a financial constraint to government and enterprise reform. This could be done in the context of resumed adjustment lending, with counterpart funds generated by Bank loan proceeds used for financing severance pay. This has already happened in the case of the coal industry restructuring. On a case by case basis, this could also be done through investment lending where severance pay may be financed directly as a component of an operation to restructure a sector, such as the education sector, or steel works, or railways.

3.54 Of course, an important concern for the Bank should be making sure that workers who have received severance packages are not rehired by the same enterprise. The solution to rehiring needs to lie in paying careful attention in the design of projects to the reinstatement of payroll controls, and the overall hardening of fiscal discipline. In the context of adjustment operations this means that (i) severance pay financing should not be considered before a fully-fledged reform program, supported by the IMF, is put in place, and (ii) severance pay financing should be available only where Bank staff makes a judgment that a robust and comprehensive sectoral or regional reform program is in place, with monitorable targets and genuine political commitment for its implementation. In practice, such a program, developed with the federal government, should make additional financing available to those regional governors who are genuinely interested in enterprise reform and who prove that they stop soft-budget constraint for enterprises.

## ANNEX 1: TABLES

**Annex 1 - Table 1: Russia: Basic Indicators 1991-97**

	1991	1992	1993	1994	1995	1996	1997	1998	1999 (est)
Consumer Prices (Annual average % change)	92.7	1734.6	874.7	307.4	197.4	47.6	14.6	27.8	60.0
GDP (Constant Prices % Change)	-5.0	-14.5	-8.7	-12.6	-4.1	-3.5	0.8	-4.6	-8.3
General Government Balance (% of GDP)	-31.0	-21.6	-7.4	-10.4	-5.7	-8.2	-7.5		
Trade Balance (Billion US\$)			9.5	21.1	17.4	17.0	16.6	14.4	
Barter Transactions in Russia Industry (% of Sales)		6	11	18	26	40	47	54 (Aug)	
Open Unemployment Rate <sup>*</sup> (% of Labor Force)									
- Registered	0.1	0.8	1.1	2.1	3.2	3.5	3.2	2.7	
- survey based	0.0	4.8	5.7	6.9	7.8	9.0	10.8	11.5	

Source: Goskomstat Rossii, 1997, *Sotsialnoye Polozheniye i uroven' zhizni naseleniya Rossii*. Moscow: Goskomstat. p. 38, World Bank, EBRD.

**Annex 1 - Table 2: Wage Arrears In Russia's Economy**

	1995	1996	1997	1998	1998	1999
	As of January, 1	As of January, 1	As of November, 1	As of August, 1	As of October, 1	As of February 1
Wage Arrears – total	4.2 trillion rub.	20.8 trillion rub.	55.3 trillion rub.	75,8 billion rub. (denominated)	88.09 billion rub. (denominated)	76.04 billion rub (denominated)
Number of enterprises with wage arrears	30.9 thousand	39.9 thousand	No data	114 thousand	138 thousand	118 thousand

**Annex 1 - Table 3: Russia: Poverty Headcounts, 1994-96**

	World Bank Estimate <sup>1</sup>	RLMS/UNC line <sup>2</sup>	Official Goskomstat Rossii <sup>3</sup>	ISEPN Correction <sup>4</sup> of Official
(In percent of population/individuals <sup>5</sup> )				
1994	37.6	17.1	22.4	42.0
1995	39.6	30.7	24.7	...
1996	43.1	36.9	22.0	34.5
(In percent of households <sup>6</sup> )				
1994	32.2	15.3	...	...
1995	33.7	28.9	...	...
1996	37.1	34.7	...	...

Source: Goskomstat Rossii 1997, p. 116; Author calculations from World Bank version of RLMS; and ISEPN *Rossiia-1997 Sotsial'no-demograficheskaya situatsiya*, 1998, p.192-93.

**Note**

<sup>1</sup> Russian Longitudinal Monitoring Survey (panel households only All-Russia Subsistence Minimum). Author calculations

<sup>2</sup> UNC (University of North Carolina) poverty line for 8 regions. RLMS panel households only.

<sup>3</sup> From official bulletins and statistical yearbook (Goskomstat Rossii 1997).

<sup>4</sup> According to ISEPN, the new poverty methodology adopted by Goskomstat Rossii in 1994 meant that the actual headcount was 42 percent but the published headcount was only 22.4 percent

<sup>5</sup> Grossed up to individuals by weighting by household size in each year.

<sup>6</sup> Goskomstat Rossii does not routinely publish data from the family budget survey on the household/family level.



**Annex 1 - Table 4: Russia: Poverty Measures 1994-96 & Short Term Scenarios, 1998-99**  
(In percent)

	P0 (Headcount)	Poverty Gap (Billion Rubles)	Gap as % of GDP
(In percent of population/individuals 2/)			
1994	37.6	24.6	4.0
1995	39.6	27.7	1.7
1996	43.1	31.1	1.4
(Poverty Scenarios)			
1998-99			
Flat 12 Decline	49.1	36.4	2.0
Poor Lose	46.9	37.9	2.3
Rich Lose	50.5	35.2	1.6
<i>Memorandum Items</i> (in billion rubles)			
GDP in 1994	610.7		
GDP in 1995	1630.1		
GDP in 1996	2256.1		

Source: Author calculations from World Bank version of RLMS data base

1/ Russian Longitudinal Monitoring Survey (panel households only)

Author calculations.

2/ Grossed up to individuals by weighting by household size in each round.

Note: Poverty gap is the total sum of money which would be required to move all individuals out of poverty if targeting is assumed to be perfect. It is the difference between actual consumption and the poverty line (the subsistence minimum) for each individual multiplied by total individuals. The poverty gap as a percent of GDP is this number divided by GDP and multiplied by 100 percent.

**Annex 1 - Table 5: Russia: Extreme Poverty Composition And Household Composition, 1998-99**  
(Composition of the Very Poor based on poverty in Percent of Population)<sup>1/</sup>

Type of Household	Base Case (1996 data)		Scenario One:2/ Even 12% Decline		Scenario Two:3/ Poor Decline More		Scenario Three: 4/ Rich Decline More	
	A	B	A	B	A	B	A	B
<i>Composition of the Poor</i>								
Children, No Elderly	55.1	56.9	54.5	56.7	54.9	56.0	54.1	55.9
Elderly, No Children	15.9	15.4	16.2	16.2	16.1	16.4	16.4	16.4
Both Children & Elderly	20.6	22.2	20.6	21.4	20.5	21.5	20.9	20.9
Neither Children Nor Elderly	8.5	5.6	8.6	10.7	8.5	6.1	8.6	6.8
<i>Composition of the Non-Poor</i>								
Children, No Elderly	39.5	44.3	38.2	43.8	38.5	44.2	38.2	43.9
Elderly, No Children	32.0	26.7	33.5	27.0	33.0	26.8	33.8	27.1
Both Children & Elderly	15.4	16.9	14.8	17.0	15.1	16.9	14.3	16.9
Neither Children Nor Elderly	13.1	12.1	13.5	12.1	13.4	12.1	13.7	12.1

Source: Author calculations based on World Bank version of RLMS data base.

Notes:

1/ 1996 household data scaled up to population size by multiplying by household size (sample was essentially self-weighting).

2/ An assumed decline of 12 percent in real consumption was distributed evenly across the distribution.

3/ A weighted average decline of 12 percent in real consumption was distributed as 7.75 % decline for the poor and a 15.5 percent decline for the non-poor.

4/ A weighted average decline of 12 percent in real consumption was distributed as 16.8 percent decline for the poor and a 8.4 % decline for the non-poor.

Should be noted that from the point of view of "newly" poor, only declines in the non-poor real consumption are significant, since the poor simply remain poor under any scenario.

4/ A denotes poverty, and B denotes extreme poverty, as discussed in the text.

**Annex 1 - Table 6: Russia: Location Composition And Extreme Poverty, 1998-99**

(Composition of the Poor based on poverty in Percent of Population)<sup>1/</sup>

Type of Household	Base Case (1996 data)		Scenario One <sup>2/</sup> (Even 12% Decline)		Scenario Two <sup>3/</sup> Poor Decline More		Scenario Three <sup>4/</sup> Rich Decline More	
	A	B	A	B	A	B	A	B
<i>Composition of the very poor</i>								
Major Metropolitan	5.3	2.9	6.2	3.2	5.9	3.0	6.7	3.4
Other Urban	58.8	53.0	59.9	54.0	59.7	53.1	60.1	53.4
Rural	35.9	44.1	33.9	42.8	34.4	43.9	33.3	43.2
<i>Composition of the Non-Poor</i>								
Major Metropolitan	14.0	11.5	14.1	11.8	14.0	11.7	13.8	11.9
Other Urban	60.6	61.0	59.7	61.1	59.9	61.2	59.6	61.4
Rural	25.4	27.5	26.2	27.1	26.1	27.1	26.6	26.8
<i>Memorandum Items: Composition of the Population</i>								
Major Metropolitan	10.2							
Other Urban	59.8							
Rural	30.0							

Source: Author calculations based on World Bank version of RLMS data base

Notes:

1/ 1996 household data scaled up to population size by multiplying by household size (sample was essentially self-weighting).

2/ An assumed decline of 12 percent in real consumption was distributed evenly across the distribution.

3/ A weighted average decline of 12 percent in real consumption was distributed as 7.75 % decline for the poor and a 15.5 percent decline for the non-poor.

4/ A weighted average decline of 12 percent in real consumption was distributed as 16.8 percent decline for the poor and a 8.4 % decline for the non-poor.

Should be noted that from the point of view of "newly" poor, only declines in the non-poor real consumption are significant, since the poor simply remain poor under any scenario.

**Annex 1 - Table 7: Russia: Poverty Among Children, Adults And The Elderly (Population Basis Data)<sup>1/</sup>**  
(Average in Members by Type), 1998-99

Type of Household	Members		Members		Members		Members	
	Base Case (1996 data)	Percent	Scenario One: <sup>2/</sup> Even 12% Decline	Percent	Scenario Two: <sup>3/</sup> Poor Decline More	Percent	Scenario Three: <sup>4/</sup> Rich Decline More	Percent
<i>Composition of the Poor</i>								
Children	1.457	36.1	1.422	35.6	1.433	35.8	1.417	35.5
Adults	2.081	51.6	2.069	51.8	2.073	51.7	2.067	51.8
Elderly	0.496	12.3	0.505	12.6	0.500	12.5	0.509	12.7
Household size	4.034	100.0	3.996	100.0	4.005	100.0	3.993	100.0
<i>Composition of the Non-Poor</i>								
Children	0.845	26.0	0.807	25.3	0.822	25.5	0.796	25.0
Adults	1.724	53.0	1.693	53.0	1.705	53.0	1.685	53.0
Elderly	0.683	21.0	0.696	21.8	0.693	21.5	0.697	21.9
Household size	3.252	100.0	3.196	100.0	3.220	100.0	3.177	100.0
<i>Memorandum Items</i>								
Overall population demographics								
Average Composition								
Children	1.109	30.9						
Adults	1.878	52.3						
Elderly	0.602	16.8						
Household size	3.589	100.0						

Source: Author calculations based on World Bank version of RLMS data base.

Notes:

1/ 1996 household data scaled up to population size by multiplying by household size (sample was essentially self weighting).

2/ An assumed decline of 12 percent in real consumption was distributed evenly across the distribution

3/ A weighted average decline of 12 percent in real consumption was distributed as .75 % decline for the poor and a 15.5 percent decline for the non-poor.

4/ A weighted average decline of 12 percent in real consumption was distributed as 16.8 percent decline for the poor and a 8.4 % decline for the non-poor.

Should be noted that from the point of view of "newly" poor, only declines in the non-poor real consumption are significant, since the poor simply remain poor under any scenario.

**Annex 1 - Table 8: Russia: Extreme Poverty Rates And Dependents, 1998-99**  
(Based on Extreme Poverty in Percent of Population)<sup>1/</sup>

Type of Household	Base Case (1996 data)		Scenario One: <sup>2/</sup> Even 12% Decline		Scenario Two: <sup>3/</sup> Poor Decline More		Scenario Three: <sup>4/</sup> Rich Decline More	
	A	B	A	B	A	B	A	B
<i>Number of Elderly Members</i>								
None	47.8	16.3	54.1	20.2	52.0	18.6	55.2	21.2
One	39.9	13.6	45.1	16.2	43.2	15.4	47.4	18.0
Two	31.5	12.2	37.6	14.6	35.5	14.4	38.7	14.8
Three	38.8	17.9	43.3	22.4	38.8	22.4	43.3	22.4
<i>Number of Children</i>								
None	30.6	9.9	35.6	12.9	33.5	11.9	36.9	13.8
One	48.6	15.9	55.6	19.0	53.1	17.9	57.0	20.1
Two or More	61.2	29.2	67.5	28.5	66.0	26.7	69.1	30.0

Source: Author calculations based on World Bank version of RLMS data base.

**Annex 1 - Table 9: Russia: Poverty Rates And Unemployment, 1998-99**  
(Based on Poverty in Percent of Population)<sup>1/</sup>

Type of Household	Base Case (1996 data)	Scenario One: 2/ Even 12% Decline	Scenario Two: 3/ Poor Decline More	Scenario Three: 4/ Rich Decline More
Number of Unemployed				
None	41.7	47.6	45.6	50.0
One	52.0	58.8	56.2	61.3
Two	42.2	42.2	42.2	42.2
Three 5/	100.0	100.0	100.0	100.0
Four 6/	0	0	0	0

Source: Author calculations based on World Bank version of RLMS data base.

Notes:

1/ 1996 household data scaled up to population size by multiplying by household size (sample was essentially self-weighting).

2/ An assumed decline of 12 percent in real consumption was distributed evenly across the distribution.

3/ A weighted average decline of 12 percent in real consumption was distributed as 7.75 % decline for the poor and a 15.5 percent decline for the non-poor.

4/ A weighted average decline of 12 percent in real consumption was distributed as 16.8 percent decline for the poor and a 8.4 % decline for the non-poor.

Should be noted that from the point of view of "newly" poor, only declines in the non-poor real consumption are significant, since the poor simply remain poor under any scenario.

5/ Results are not representative; only 15 households reported that they had three unemployed members.

6/ Results are not representative; only 6 households reported that they had four unemployed members.

**Annex 1 - Table 10: Russia's Transfers: Incidence Analysis, 1994-1996**  
Concentration (Gini) Coefficients for Transfers

	1994 Ex Ante Recipient	1995 Ex Ante Recipient	1996 Ex Ante Recipient
<i>Public Transfers</i>			
Pensions	59.1	52.1	55.9
Child Allowance	35.9	34.5	38.3
Fuel Allowance	35.5	33.9	38.0
Student Stipends	35.2	34.0	37.8
Unemployment Benefit	35.4	34.0	37.9
<i>Private Transfers</i>			
Alimony	35.6	34.1	38.5
NGOs	36.8	34.9	38.3
Relatives	42.4	41.8	52.5
<i>Memorandum Items</i>			
Ex-Ante Consumption, no public transfers	59.9	52.6	55.9
Ex-Post Consumption	47.3	43.8	47.2

Source: Author Calculations from the World Bank version of the RLMS dataset.

## ANNEX 2: COMMUNITY SOLIDARITY FUND

1. A Community Solidarity Fund could be set up as a new social services delivery mechanism, to cope with the problem of ineffectiveness of the existing delivery mechanisms. The CSF will enable to provide: (i) a flexible, multi-sectoral approach to financing local *socio-economic projects* that can target the poor; (ii) a mechanism to complement the existing system and *improve overall capacity* to meet priority social service needs at the local level; (iii) can help in the introduction of innovative approaches in *delivering social services* at the local level, especially in encouraging the *participation* of the beneficiaries (financial participation, preparation and implementation of sub-projects); (iv) a way to introduce mechanisms to *reduce the risk of corruption* and misuse of funds and demonstrate new approaches in this area which can be integrated afterwards in local government procedures; (v) a way to *build local capacities for community development and mutual support* through involvement in a clear and organized way all stakeholders in the delivery of social services (state, region, raion, local municipalities, social services, NGOs and associations); (vi) a way to *introduce competitive mechanisms* at the local level through bidding of local institutions for sub-projects; (vii) an instrument to *encourage partnership* between different levels of government and private and civic organizations in the fight against poverty; (viii) a way to *efficiently channel donor funding* directly to beneficiaries.

2. The short-term immediate objectives of the CSF would be: i) a rapid response to *priority needs* expressed by the community; ii) improved quality of social and economic services *directly targeted* to most vulnerable population groups and areas (street children, orphans, elderly and other identified by communities); iii) *built local capacity* in social service delivery (municipalities, communities, local associations, NGOs etc); iv) *temporary employment* generated through financing labor-intensive public works; and v) strengthened *capacity of private small-scale contractors* and other micro-businesses so that they can benefit directly or indirectly from contracts financed by the project.

3. In the long term the CSF can contribute to: i) an improved quality of delivery of community-based basic social and economic services for poor segments of population; and ii) developed community solidarity sense through encouragement of community initiatives and strengthening their decision making, organizational and managerial capacities.

4. The CSF project could be implemented in two phases: i) pilot project and ii) main investment project. The pilot project can be implemented with the assistance of the interested donors and should target at least three pilot oblasts to provide a representative sample of oblasts in order to: i) test the proposed mechanism and provide lessons for the design of the main fund; ii) demonstrate to the Government, donors and communities the benefits and impact of demand-driven financing mechanism; iii) prepare the establishment of the main fund; and iv) develop sub-project criteria, the CSF Operational Manual, Management Information System, including the financial management and monitoring systems; v) develop a targeting map and resource allocations matrix for the main fund. At the end of the pilot project a beneficiary impact assessment study could be undertaken, which along with financial and technical audit reports could serve a basis for drafting “lessons learned” pilot evaluation report.

5. The CSD should support local level initiatives identified by institutions which are as close as possible to the beneficiaries. The sub-projects financed by the CSD should be implemented by small urban and rural municipalities, local associations and NGOs with good track record of implementation, with support from raion level administration. The system should be set-up to respond to demand. The local level organizations should identify needs, prepare sub-project proposals, enter into a contract with the CSD for the implementation of the sub-projects when approved by the CSD regional selection committee,

implement the sub-projects, report regularly to the CSD supervisor and the community on the progress of the sub-project.

6. Targeting and monitoring should be key to ensure effectiveness of CSF operations.

7. **Targeting** could be carried out through the following three ways: (i) geographic targeting -- considering the size of the Russian federation CSD programs can be successful only if very well targeted. The project will need to develop a geographic targeting matrix and identify oblasts (and raions within the oblast) and prioritize them for intervention. It would be very important to ensure that the participating regions accept to collaborate with the CSF based on the rules define in the Operational Manual; (ii) poverty targeting -- participating oblasts should be identified through a needs and capacity assessment carried out based on sound criteria, such as, for example: high level of poverty, high level of arrears in payment of wages and benefit to the population, high level of unemployment, lack of availability of food and essential goods, some indicators of social stress etc. However, much more precise criteria will need to be developed during the pilot phase; (iii) at the sub-project level a self targeting mechanism should be used to support the community initiative and activity at first-come first-served basis and through the detailed menu (typology) of sub-projects eligible for funding. The sub-projects should be implemented in areas with special needs for special programs.

8. **Monitoring** will be essential to the success of the project and for that reason should be its major component. The monitoring system with the following three essential components should help to ensure the proper use of funds: (i) **studies and audits** -- the following special studies could be conducted by the external evaluators on the annual basis: a) beneficiary impact assessment study of 10% completed sample sub-projects; b) procurement and technical audit to evaluate a quality of civil works and procurement practices of sample of 10% of completed sub-projects; c) financial audit evaluating project financial performance; and d) performance audit to evaluated the compliance with procedure established in the Operational Manual. The results of studies should be widely published to ensure transparency of the project; (ii) the **Management Information System** (MIS) which could be developed during the pilot project and linked to the financial/management and accounting system should be a cornerstone tool of the CSF monitoring effort. It should support detailed day-to-day project monitoring including physical progress, financial monitoring, payments and strategic management decision-making; (iii) **sub-project monitoring** should be conducted by the beneficiaries through the following procedure to be established in the Operational Manual: a) every sub-project should have to have a local supervisor permanently present at the site to monitor the quality of the civil works and verify the quantity of the completed works eligible for payment; b) the implementing agency should verify works completed by the contractors and issue the payment requests to the CSF; c) the CSF staff should sign off every request for payment; d) the CSF staff/consultants will have to conduct random follow-up visits to the participating communities to monitor the social impact and progress of works; e) the implementing agencies should be required to inform beneficiaries about progress of sub-project on a regular basis through public meetings, publication of results etc.; and f) regular internal audits should be conducted by CSF internal auditors.

9. **Project typology** -- the CSF may fund a range of programs. The menu/typology of sub-projects eligible for financing under each programs should be determined during the project preparation based on the lessons learned from the pilot project. The following programs can be considered for financing:

***a) support for the improvement and scaling up of social services for vulnerable groups unable to work***

This program would be mostly targeted at street children, but could also include program of outreach for pensioners living alone and handicapped outside of institutions. The program should support the sub-projects of outreach for these groups and could consist of activities such as community shelters, soup kitchens, program to support children in difficult situation to stay in schools etc. mostly through small-scale investments for: i) rehabilitation of building; ii) small essential equipment and furniture, iii) special programs; iv) short term training; v) technical advice to improve maintenance and sustainability of the operation etc. The average size of sub-projects should be around US\$ 40,000.

***b) support for the improvement of community-based social services for small isolated cities and villages***

This program would particularly focus on improvement in the delivery of basic community-based social services through financing: i) civil works for rehabilitation of community-owned kindergartens and schools, local health posts, small water supply, sewage and sanitation systems, community centers, and environmental sub-projects such as clean up, tree planting, soil erosion control, and landslide rehabilitation etc.; ii) small equipment and furniture; iii) training/retraining of personnel of rehabilitated facilities and community members; and iv) innovative social programs. The average size of sub-projects would be about US\$ 100,000.

***c) support for the improvement of community-based economic services for small isolated cities and villages***

This program would support sub-projects aiming to improve the basic economic infrastructure to help communities to gain better access to main markets and provide better service essential for improvement of economic situation of the population through financing: i) civil works for rehabilitation of community access roads, market places, community bath, local communication system etc. ii) training of community members and technical assistance; iii) innovative programs in training of business skills, retraining etc. The average size of sub-projects would be about US\$ 100,000.

10. The CSD institutional set-up should have the following key features: (i) the CSD should be established as an ***autonomous institution*** which should operate according to a clear division of responsibilities between different actors and in particular between different level of the government. It will need a ***legal status*** which will enable it to enter into contractual agreements with other legal entities and adopt its own procedures for disbursement of funds. The structure does not need to be permanent, it can be set-up for a specific period of time. The CSF should be in a position to sign agreements with subjects of the federation to ensure clear understanding of the way the fund should operate in each region; (ii) the CSF should have a ***Board*** which will oversee the activities of the CSF executive office and define the policies of the fund. It should be composed of 6 to 8 members with at least two to three members not from the government (trade union, university/research, NGOs or other civil society organizations). The Board should review and approve the CSF ***Operational Manual***, approve annual program and budget, quarterly and annual progress reports, approve the regional allocation of funds based on the targeting mechanisms, on a competitive basis designate the director of the executive office and appoint auditors; (iii) the CSF should have an ***Executive office***, headed by the CSF executive director. The executive office should be responsible for the promotion of CSF activities, appraisal of sub-projects submitted by local institutions. The executive office should ensure that the secretariat of the local approval committee is in place, will enter into contract with the local implementing agencies, disburse funds to local contractors and implementing agencies, monitor the progress of the sub-projects, monitor the impact of the sub-projects, maintain the targeting map updated, maintain Management Information System. The CSF office at the center should be small and it should open temporary field offices in areas where the fund is operating; (iv) CSF should have ***local offices*** which should also be small and should hire locally

supervisors and promoters who after receiving short-term training should be able to carry out their tasks. Local offices should have at least a head, an accountant/financial officer, a permanent promoter and a permanent appraisal officer and follow-up officer as well as program specialists; (v) **local level approval committees** should be set-up in each targeted region or area of intervention of the CSF (group of raion). They should include representatives of the region, of the raions, of local civil society organizations (NGOs, universities, academia, chambers of commerce etc.) and the representatives of the CSF as an observer. They would approve sub-projects appraised by the CSF local offices; (vi) **implementing agencies** can be municipalities, village councils, association of beneficiaries, NGOs and other local/community-based organizations. They should prepare sub-project proposal, enter into contract with the CSF once the sub-project is approved, select contractors and suppliers according to the procurement procedures defined in the Operational Manual and implement the sub-project.

11. **Sub-project approval** should be based on the sound selection and evaluation **criteria** which should be approved by the Board and clearly reflected in the Operational Manual. The developed criteria should assess the sub-projects for: (i) social; (ii) institutional; (iii) economic; (iv) technical; and (v) environmental soundness using the indicators such as community needs (maximum social benefits to poor/vulnerable), capacity of community to participate and contribute to the sub-project, sub-project size and cost limits, cost-effectiveness (cost per beneficiary, cost per basic unit etc.), sub-project technical feasibility and labor intensity (local employment generation), feasibility of operations, maintenance and sustainability plans etc. The two criteria provided below should be a particular focus of the CSF appraisal: a) **participation** -- the sub-project should respond to the actual demands of the groups and communities initiating proposal. In order to demonstrate their commitment the requesting institutions (NGO, local government, community etc.) will have to share the investment cost with the CSF. The contribution can be made in form of cash, in-kind and/or labor and should be at least of **20%** of total sub-project cost; b) **sustainability** -- the sub-projects should have a well-developed operations, maintenance and sustainability plans with elements of cost-recovery mechanism. Recurrent costs should remain the responsibility of local organizations.

12. The CSF would be expected to have the following **outputs**: i) improved delivery of basic essential social and economic services in targeted communities; ii) rehabilitated infrastructure facilities; iii) improved capacities of local government and other local institutions in delivery of essential social services; iv) improved living standards of targeted vulnerable groups of population; v) temporary jobs created; and vi) improved capacities of local contractors for competing and executing contracts under market conditions.



### ANNEX 3: TARGETING INITIATIVE

1. This annex lays out a possible plan for targeting local social assistance in response to the ruble devaluation/financial crisis of late 1998 as well as the general need to improve the provision of social assistance. There is a greatly increased need to target social assistance in the wake of the ruble crisis. Also, there exists Russian experience with targeting that could rapidly be expanded to improve the delivery of social assistance to the poor and to build consensus about the social equity of targeting the poor. The targeting initiative (TI) could be undertaken relatively quickly, given the unanimity of opinion on the desirability of targeting among the various layers of government (federal, regional/local, Parliament) and the experience of the Government of Russia (GOR) in piloting targeting of social assistance in three oblasts of Russia. The note details the following aspects of the possible TI: the description of the component, the justification for the component, the existing Russian experience, the possible role of the Russian “know-how” team, the geographic selection of oblasts for participation in the process, the system of monitoring and supervision of the project process and outcomes, and the strategic issue of how to roll out the component to eventually cover geographically the entire country.

2. **Description.** The TI consists of expanding targeting of local social assistance from 3 pilot oblasts to an additional number (to be determined) of oblasts during a specific time period (such as a calendar year), as an immediate response to the sharply constrained financing abilities of local governments in the reaction to the ruble crisis. The TI is a possible GOR-World Bank investment project (or component of an investment project). The TI includes the transfer of knowledge about targeting from the pilot regions, the GOR, and the World Bank through training efforts, and investment components in monitoring and computerization of local social assistance offices. The project might be implemented by a “know-how” team, consisting of Russian experts, as counterpart to the World Bank team. Under World Bank operational manual standards, this component has a poverty category of PTI (poverty targeted intervention).

3. **Justification.** There is a strong general consensus among the various layers of federal and local government and Parliament, that most social assistance and government transfers are not targeted to the poorest. Targeting means the identification of the poor or most needy and reaching them with a social benefit or service. The newly formed GOR has announced that targeting of social benefits would be the guiding principle of its social policy. This is a genuine commitment to the principle of targeting—that help should go to the poor. However, there is somewhat less recognition that targeting is costly, and requires administrative expenditures for successful implementation, which itself is a complicated undertaking.

4. Targeting is clearly the direction that the GOR intends to take, and must take, in order to rationalize social assistance provision in Russia, to redirect payments from the non-poor to the poor, and to reduce or reallocate the fiscal burden associated with a system that is highly regressive in nature (paying out primarily to the non-poor). The social assistance pilot experience presents a tremendous opportunity for the GOR to engage in a win-win dialogue with the oblasts and with the Bank, to extend the Russian experience gained to the remaining 86 oblasts, and to create a social protection system that is perceived to be, and is, equitable and targeted towards the poor.

5. The social assistance pilots are a clear example of poverty reduction efforts which cut across sectors and involve considerations for both poverty reduction and human development objectives. On the poverty reduction aspect, the social assistance pilots present the opportunity to reduce the long-term fiscal burden of both direct cash and in-kind transfers (*posobiya* and *l'goty*) and cross-subsidies on

utilities and housing, by presenting an equitable targeting mechanism for identifying and reaching the poor.<sup>5</sup>

6. On the human development side, the pilots represented the unique chance to target benefits correlated to poverty, instead of relying on infeasible, expensive, and impractical recommendations to test statutory income only (often unpaid and exclusive of informal earnings) or to retain the outdated categorical approach inherited from the previous regime which excludes the newly poor, particularly families with children and with unemployed or under-employed members.

7. **Existing Experience in Russia.** At least one-half of Russian oblasts have some form of targeting in place for the allocation of locally-financed social assistance benefits. Additionally, the GOR in conjunction with the World Bank conducted experiments in targeting in three oblasts. These targeting pilots consisted of a system for monitoring baseline and outcome data, the introduction of an experimental targeting methodology, and the payout of a temporary benefit for the poorest of the poor. Most of the existing methodologies would require significant vetting and modification before they could be used for reliable targeting. Reliable targeting was achieved by the successful implementation of three different targeting systems in three very different oblasts (Komi, Voronezh, Volgograd) of Russia, demonstrating several key facts: (i) the feasibility of targeting, in addition to its necessity; (ii) increase in social consensus in the oblasts that introduced targeting; (iii) increased importance of targeting in the time of crisis; (iv) the importance of transparency and conciliation commissions of client dissatisfaction (see Chapter 3 of the report for details).

8. **Know-how team.** The Russian social assistance pilots were implemented by a primary team of three World Bank experts and one main GOR counterpart in the Ministry of Labor and Social Development, along with three separate Russian research institutes (one per oblast) and the local authorities. The pilots supervision period ran for 12 calendar months, but with interruptions in the program and a very long lead time, the entire exercise required almost two years. Since the expansion of the pilots in the TI will build directly on this previously-prepared groundwork, it is expected that the TI can be accomplished within one calendar year of its formal signature by the GOR. However, for this ambitious goal to be realized, supervision will have to be delegated to a much larger team of actors and the rollout contained to a few selected oblasts. One possible mechanism would be the creation of a Russian “know-how” team with responsibility for implementing improved targeting. Staff for such a team could be drawn from the local research community, especially given the expertise accumulated by the three Russian research institutes (SOTEKO, VTsUZh, ISEPN) in the course of the social assistance pilots, as well as qualified government employees. However, the logistics of rolling out targeting expertise in a country with 11 time zones are quite challenging and should not be underestimated.

9. **Geographic Selection.** The single most important criteria for the selection of which oblasts should be included in the TI are the *openness* and *willingness* of oblast governments to participate in the project. Local governments will be required to demonstrate their willingness by financing from local resources a random sample survey of individuals before and during the implementation phase to monitor poverty impact (see below) and to also self-finance focus groups of those who received and who were denied social assistance under the new/reformed methodology.

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<sup>5</sup> The country faces a challenge with cost recovery in many major areas, such as housing, energy, communications and utilities. There are two issues: general cross-subsidies which are given to all (i.e. the price of the metro in Moscow is low for everyone) and there are numerous special benefits (l'goty) which are given to privileged groups such as the elderly, veterans, people who work in certain occupations, and etc. While indeed some of these privileged groups may be poor, there is clear evidence that the vast majority are not.

10. **Monitoring and Supervision.** The three social assistance pilots were carefully designed to provide several different kinds of monitoring:

- monitoring of the quality of work of social workers
- monitoring of finances from central and local sources<sup>6</sup>
- mid-term course correction for methodologies
- monitoring of administrative costs
- planned monitoring of beneficiaries and those who did not receive benefits
- monitoring of actual pilot outcomes (survey)

11. The TI will require similar monitoring emphasis and will rely on most of the same methods which were used to monitor the pilots. In particular, the quality of the work of social workers will continue to be a local responsibility, although “know-how” team members will be expected to attend in-take sessions, obtain and give direct feedback to social workers, and canvass clients during their site visits (as previously conducted for the pilots).

12. The “know-how” team or other implementing agency will conduct mid-year reviews of all the participating oblasts, approximately 6 months after the implementation of a revised targeting methodology has begun. The most important aspect of the mid-year review will be to gather local recommendations about how to further refine the targeting methodology, and to adopt immediate improvements where warranted.

13. The “know-how” team or other implementing agency will set up a system of monitoring of administrative expenses in every participating oblast. Oblasts will be responsible for monthly and quarterly reporting of number of applicants, number of payouts and rejections, profile of recipients, and tracking of administrative costs.

14. As part of the oblast’s contribution in kind and beginning with the mid-term review, focus groups of beneficiaries and those who applied but did not receive the benefit will be conducted under the supervision of the “know-how” team.

15. Oblasts will also cover the local costs (staff time, local transportation costs, data entry) of a sample survey of the population to monitor the baseline data and outcomes. The survey sample will be constructed as a three-stage panel, with survey fieldwork occurring immediately after the selection of the oblast, at mid-term review, and after a year of implementation experience. The survey will use a questionnaire similar to the pilot sample survey questionnaire, and the “know-how” team will provide expertise on drawing the sample. It is expected that the local Goskomstat affiliates would provide the interviewers staff time and transportation expenses, and would complete initial data entry work locally.

16. **Rollout.** Targeting should not be perceived as for experimental benefits only, when actually it can be used extremely effectively towards targeting any benefit, whether in cash or in kind. First, the introduction of targeting for local social assistance eliminates the old categorical approach which excludes the new poor, especially families with children and the unemployed. Before the introduction of the pilot benefit in the three oblasts, local authorities were limited to helping such families only by the so-called “one-time assistance” which was often not enough to bring the families out of poverty. The TI will enable local social assistance offices to use better criteria for the selection of beneficiaries. By

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<sup>6</sup> The experimental pilot benefit was co-financed by the federal and local budgets. The TI is intended to cover only existing locally-financed social assistance and not to introduce an experimental cash benefit.

eliminating allocation of benefits to the old privileged categories through targeting, resources could be freed to reach the poorest of the poor.

17. Other important lessons of the pilot experience will be applied to the roll-out of targeting through the TI:

- The importance of paying poverty-targeted benefits in cash wherever possible. Countless respondents and social workers have informed the GOR and World Bank that the provision of a timely benefit in cash was crucial for families to resolve problems such as immediate need for food, for transportation to search work, or for the purchase of medication or school supplies. Without the general-purpose nature of cash money, no system could have identified all these individual needs and met them successfully through any sort of mechanism for distribution of in-kind items.
- Even so, it may not be possible in the short-run for many or any oblasts to continue paying social assistance in cash, due to the pervasive nature of the mutual settlements (i.e. barter system) in which local taxes are paid and collected in kind. Nonetheless, the lessons learned about identifying who in the crowd of the needy are the most needy can easily be applied to any benefit, whether in cash or in kind. As the financial situation normalizes and the country remonetizes its economic transactions, then the very same targeting mechanism could be applied to the most efficient kind of benefit--a poverty benefit paid out in cash.

18. Eventually, after the TI oblasts are provided with reliable targeting methodologies and computers for local social assistance, the targeting efforts should be expanded to the remaining oblasts in a phased manner, possibly over a three-year horizon. At the same time, targeting could be expanded in the TI oblasts to cover areas other than local social assistance, including the payment of in-kind benefits to privileged groups.

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### **Summary Findings**

This report focuses on changes in the social protection system to lessen the social impact of the economic crisis that confronts the Russian Federation today. The report is not comprehensive and covers exclusively the crisis-related issues. It addresses the key challenges of (i) coping with income decline and increasing poverty, (ii) offsetting the consequences of reduced public expenditure in the social sectors, (iii) targeting and delivering social assistance and benefits, and (iv) improving the functioning of labor markets. It also deals with selected aspects of emergency assistance. Finally, it identifies possible areas for Bank support.

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